IRS AUDITS – THE GOOD NEWS!

By

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At the end of a recent IRS audit, the taxpayer received a letter from the IRS stating "We are pleased to tell you we did not make any changes to the tax reported on your return". ***That was very Good News***!

While there is no iron clad way to avoid an audit, there are strategies that can be put in place to minimize the chance to be audited, and if selected for audit, then supporting documents should adhere to the IRS rules and definitions, and certain strategies can be followed to obtain maximum results. The following overview outlines these strategies and planning techniques.

First, let's look at some of the reasons tax returns are generally selected for audit:

1. Random selection.
2. Computer screening – based on a statistical formula (did Interest Expense or Real Estate Tax exceed the national averages), or "did your Discriminate Function Score" (DIF) exceed a certain level. DIF is the IRS acid test prepared by a computer construction of your statistical profile, which compares you to a group of people who have previously been audited, and assessed additional taxes. It is estimated that over 85% of audits result in additional tax assessments. As stated in 'Deduct It! Lower Your Small Business Taxes" by Stephen Fishman, J.D., approximately 25% to 65% of audited tax returns are selected this way, and some of the known factors the formula takes into account are:
    a) The nature of your business (large amounts of cash employed).
    b) Where you live (high audit rate in CA, NV, CO, and some states in the northeast, except Manhattan).
    c) High deductions relative to income.
    d) Hot button deductions (auto, travel, entertainment expenses).
    e) Business that loses money.
    f) Sole proprietors are most likely to be audited.

3. Document matching- W-2's, Forms 1099 reported by payers do not match the amounts shown on the tax return.
4. Related examinations – transactions with other entities being audited.

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5. Other Red Flag items that cause a tax return to be selected for audit are deductions for a) Bad Debts, b) Casualty Losses, c) Charitable Contributions (if above 10% of income), and d) Home Office.

Next, notification of an audit can be made in two ways; by mail, or by telephone with subsequent letter confirmation, but **never** by e-mail. In addition, the taxpayer's rights include knowing why the IRS is asking for information, the right to representation by oneself or an authorized person, and the right to appeal disagreements.

Normally the audit period will not exceed a three year period, but can extend to six years if substantial underreported income is alleged. In addition, there is no statute of limitation if fraud is suspected.

In his book "How to Beat the IRS at Its Own Game", Dr. Amir Aczel discusses the variables in a tax return that triggers the DIF to select a tax return for audit. As a Statistician he analyzes the variables with what he calls the *"Personal Accounting Ratio"* or (PAR), which is the ratio of two quantities that appear on a tax return. For example, for <u>Schedule A, Itemized Deductions</u>, there is a statistical significance when taken as a ratio of Adjusted Gross Income (AGI). If Schedule A totaled $15,000, and AGI was $60,000, then the ratio or (PAR) would be 0.25 or 25%. You can apply the (PAR) ratios to Total Expenses on Schedule C to Total Schedule C Income, and other areas as well.

Based upon a study of tax returns that were selected for audit, Dr. Aczel compares each PAR to the IRS's DIF profile, and has created a gauge to determine whether a tax return is likely to be audited. The gauge for Total Itemized Deductions shows that the ratio range that is a "caution zone" is 0.36 to 0.44, and the critical zone is above 0.44. The gauge <u>for Schedule C Expenses</u> shows a "caution zone" of 0.52 to 0.63, and a critical zone starting at 0.63.

If your PAR exceeds the Critical Point for any of the variables tested, and is fully justifiable, then it is recommended that you add valid supporting documents, and a detailed explanation to the tax return for the deductions that caused the inflation. This will minimize the risk of audit when the IRS classifier reviews the DIF selected tax return.

Other areas to consider which may minimize the risk of audit are:

1. File an Extension of time to file, as late as October 15th, since the DIF selection starts right after April 15th, and audits need to be selected soon thereafter, so that they can be completed within a 3 year limitation period.
2. Never file a subsequent year's tax return when you are under audit. Why give the auditor another year to audit at that time?
3. Avoid filing amended tax returns whenever possible, since that creates a greater risk of audit.
4. Remove Schedule C from your Form 1040, and instead report as a partnership or corporation.

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This may be obvious, but cannot be stressed enough. To minimize the risk of audit, it may be advantageous to change the form of entity used in business income and expense. Schedule C, the form used to report income and expenses of a Sole Proprietor has one of the highest rates of selected items for audit, especially when gross revenue exceeds $100,000. One suggestion is to form a partnership, LLC, or corporation to operate the business activity instead of as a Sole Proprietor. The detail of income and expenses is removed from Form 1040, and is reported on Form 1120, 1120S, or Form 1065. Form 1040 includes income from Form W-2, and from Schedule K-1 for taxable income or loss of the entities.

Tax deductions are lost mainly as a result of lack of documentation. Therefore, during the tax preparation process, keeping timely and accurate records, especially if deducting travel, entertainment, gift, or transportation expenses, is the best planning mechanism. The amounts reported can then be substantiated and documented to allow for full deduction. In the case of entertainment expenses they must be both ordinary and necessary. IRS Publication 463 includes a complete guide to the rules and recordkeeping for deducting Travel, Entertainment, Gifts, and Car Expenses.

> This article has been an overview of minimizing the risk and/or planning properly for a potential IRS Audit. Suffice it to say as noted in Publication 463 that “you should keep adequate records to prove your expenses, or have sufficient evidence that will support your own statement. You must generally prepare a written record for it to be considered adequate. This is because written evidence is more reliable than oral evidence alone. However, if you prepare a record on a computer, it is considered an adequate record. You should keep the proof you need in an account book, diary, log, statement of expense, trip sheets, or similar record. You generally must have documentary evidence such as receipts, canceled checks, or bills, to support your expenses”.

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