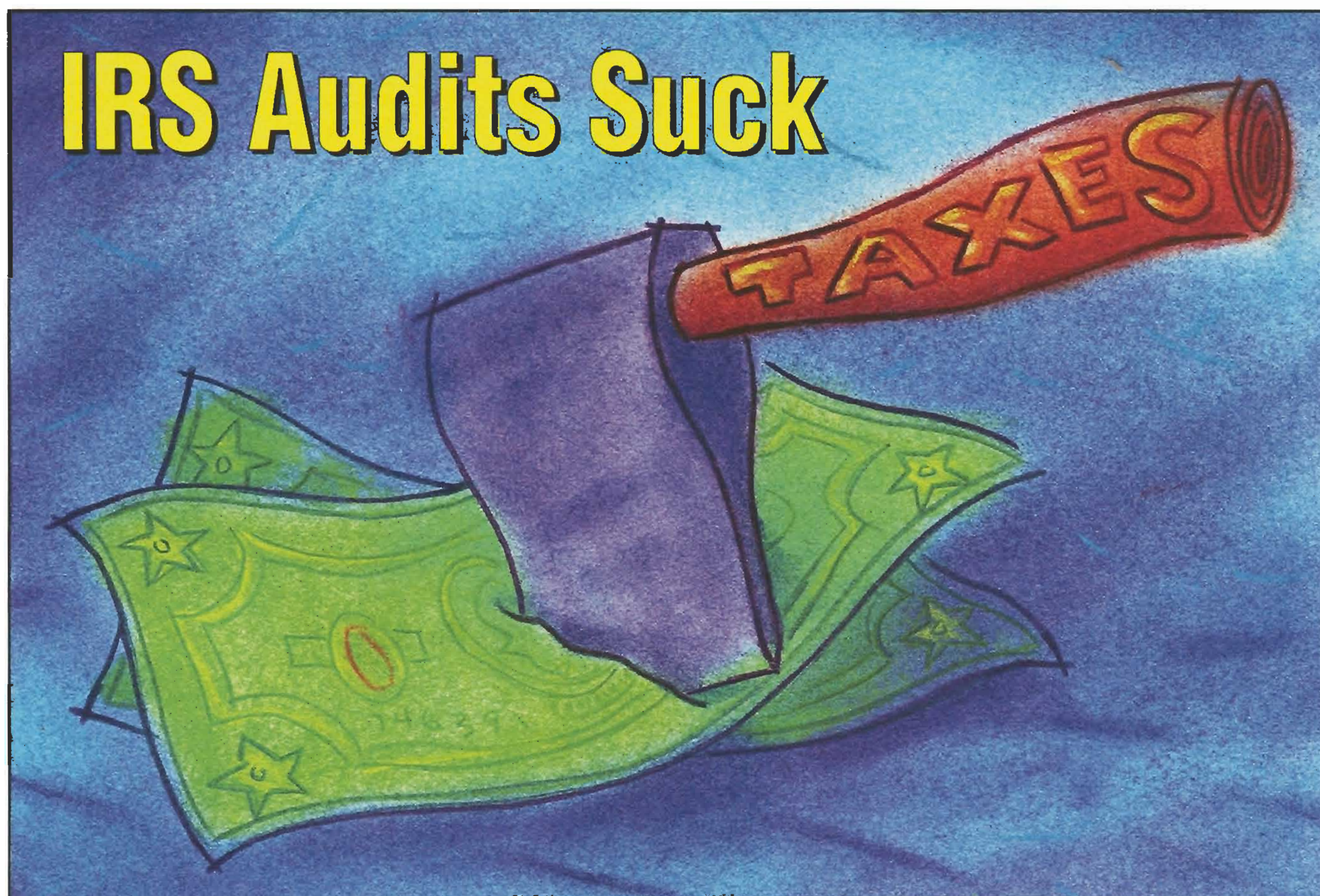
by Alan Friedman

IRS Audits Suck



I spent hours trying to come up with a politically correct title for this month's Think Tank. Some of the strong contenders included: "An Essay on the Similarities Between Root Canal Surgery and IRS Audits"; "IRS Audits: Autopsies Without the Benefit of Being Dead"; and my favorite, "IRS Audits: Just Bend Over." In the end (no pun intended), I decided to keep it simple and to the point. Let's face it, IRS audits do suck.

People like me, who provide tax preparation services, always have great IRS audit stories. As you can imagine, some of these are horror stories, and some are tales of lucky breaks. In addition to their entertainment value, these experiences teach us what "to do" and what "not to do" when preparing and defending a client in an IRS audit. Accordingly, I thought I'd share some of my 20 years of audit experience and insights. You may not find this stuff entertaining, but if you take heed of the known audit traps and follow a few simple suggestions, you too can survive an IRS audit and be able to laugh about it someday.

Return to Sender

When you get any correspondence from Uncle Sam, open it immediately. I know that sounds stupid, but you wouldn't believe how many taxpayers are afraid to (and consequently don't) open letters from the Internal Revenue Service. Don't panic just yet, as there's five varying "types" of audit letters:

1. Correction Letter. Least threatening, a correction letter is not a true audit. It merely highlights apparent mathematical errors and/or discrepancies in your tax return. Most common are the inconsistencies found by the IRS "matching" program, where the IRS cross checks income reported by payers (i.e. savings account interest on Form 1099-INT) with income reported on your return.

2. Correspondence Audit. The correspondence audit letter requests verification of items reported on your tax return. Usually the IRS is just looking for documentation to support the tax treatment of a particular item (like proof that you rolled over an IRA distribution). This type of audit is usually easy to resolve by mail.

3. Office Interview. The office interview usually indicates the IRS has a more serious concern about your return. You or your representative will meet with the revenue agent at the IRS office. Usually, the IRS agent is looking to focus on a specific area (i.e. business deductions).

4. Field Audit. The field audit is usually associated with business audits. The auditor will come to your place of business, looking to examine business income and deductions. This usually is not a fun experience, as there's no telling when the auditor will go home. I have found there tends to be some correlation between their "going

home" and an additional "tax assessment" from their audit findings.

5. Taxpayer Compliance Measurement Program (TCMP). The TCMP audit was created either by Satan or revenue agents who were abused as children. Also known as the "super audit," this examination requires you to verify every item on your tax return—even your name and social security number. I suppose if "your sex" were a question on your tax return, you'd have to verify that too. The IRS uses the results of this program to highlight areas of noncompliance and to determine where to focus their regular audit efforts. Luckily, none of my clients have ever gone through a TCMP audit. But I suspect that will soon change, now that I've compared the IRS to Satan.

Do You Feel Lucky, Punk?

Chances are that only 1 percent of you will be audited in any given year. I've known some taxpayers who I thought for sure would get audited and didn't; others who got audited for no apparent reason. But there are some trends in who has the highest risk of audit. The higher your income, the greater your chances of an audit. A self-employed taxpayer (who files a Schedule C) has a greater likelihood of audit. And more than 40 percent of all estate tax returns containing the valuation of a closely-held business (like a music store) are audited. Why? Because these taxpayers represent the IRS' best chance for collection of additional tax revenue. For example, a self-employed taxpayer can wind up paying more than $1,000 of additional income tax, self-employment tax, interest and penalties from an IRS audit disallowance of a $2,000 travel deduction.

The main tool used by the IRS in selecting returns to audit is the Discriminate Income Function (DIF). Each return is scored by the DIF for audit potential. DIF scores increase as deductions are compared to income, causing the "red flag."

Absent fraud or a substantial understatement of income, the IRS has three years from the due date of your return to initiate an audit. So you can stop worrying about the $893 deduction on your 1978 tax return for taking your store's 17 employees to Pizza Hut and the Journey-Foghat-Montrose concert (it was probably deductible anyways).

Risky Business

Here are just a few of the higher risk areas that improve your chances of audit:

- Reporting passive income or losses;
- Claiming tax shelter write-offs;
- Making tax protest statements on your return (duh!);
- Working in occupations that produce "cash" income (like music stores);
- Being self-employed;
- Reporting related party transactions (i.e. rent from your business to you, wages to your kids, bad debt deduction for money lent to a relative);
- Earning higher levels of income (over $100,000);
- Large charitable contributions;
- Having a complex return and preparing it yourself;
- Using a tax return preparer who's on the IRS' Problem Preparer List;
- Taking tax deductions for items that the IRS feels taxpayers tend to stretch the truth (such as home office deductions, auto expenses, insurance, travel, meals and entertainment).

When auditing your returns, the IRS also uses "economic reality" tests to help identify cases of underreported income. When reported income is inconsistent with a taxpayer's lifestyle (type of auto driven, neighborhood lived in, college expenses paid, etc.), the IRS will ask the taxpayer to reconcile these differences. Just like Lucy, you'll have some serious splainin' to do.

Big Brother & the Tax Holding Company

Taxpayers often think of the IRS as "Big Brother" and feel that auditors have access to every known piece of information about them. This fear works wonders in assuring taxpayers accurately report their income and expenses on tax returns. It also works in an audit by intimidating a taxpayer into providing a wealth of information, making concessions and revealing way more than the auditor needs to know about.

Interestingly enough, the IRS auditor's tax file on you has only three items: the tax return being audited, your tax history for the past six years and a list of third-party payments made to you. The tax history merely tells the auditor whether you filed returns, were previously audited or had a tax liability adjusted. The list of third-party payments allows the auditor to make sure you reported this income (usually from 1099s) on your tax return.

Copies of prior tax returns are not in their file (which is why audit letters usually ask the taxpayer to bring copies of the preceding and subsequent year's tax return to the audit). Bear in mind, you're only required to provide the IRS auditor with information relating to the specific year being audited. You are not required to provide copies of any other years' tax returns, even if the auditor asks for them. The only information from a previous year's tax return that you may need to provide relates to carry-over items in the audited return, like depreciation or capital losses.

The auditor doesn't have copies of your bank statements, canceled checks, property deeds or a list of the X-rated flicks you rented last month. Hence, if information that could cause you audit problems is not in the auditor's file, odds are in your favor the auditor doesn't know about it. That is, of course, unless you tell him. So, Shaft, shut your mouth.

Just Say No

As crazy as this sounds, sometimes it's OK to say "no" to an auditor. If an auditor asks you for a prior

year's tax return or information that has no bearing on the current year, remain polite and simply respond to any such request with "I do not believe that information relates to the year or issues being examined per your audit notice." I've found this approach favorable to "Hey, back off, Jack" especially when the auditor's name isn't Jack.

Clearly, the best way to avoid saying too much or finding yourself providing information outside the scope of the audit is to have someone else represent you at the audit. Frankly, I rarely let a client attend their own audit. Having your CPA or attorney represent you at an audit will greatly reduce the risk of providing more information than is absolutely necessary. Why? A few reasons.

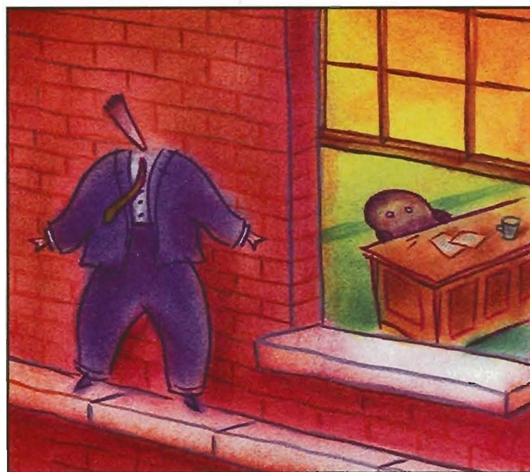
First, your CPA or attorney won't know the answers to any "fishing expedition" questions the auditor might ask. You'd be surprised by how much information taxpayers will unintentionally reveal about themselves. "Why yes, Mr. Auditor, those are valid travel costs for attending our industry's NAMM Convention in Anaheim. My wife and I go every year, as it gives us an opportunity to do some business, visit Disneyland and go shopping in Newport Beach." (A perfect example of the client from hell).

Second, the CPA or attorney won't bring any extraneous information to the audit. We require all document requests in writing and then, together with our clients, draft answers in the most concise, truthful, unrevealing manner possible. This approach also slows the process which may deter an auditor's attempt to expand the audit to other years.

Lastly, the CPA or attorney is not emotionally charged, living in fear or otherwise upset about the audit. They can be completely professional without bringing any emotions or personal factors into the audit. We are practiced at being pleasant, calm and rational (until a client doesn't pay us—just kidding), while knowing the rights of the taxpayers we represent.

Time, Money & Ulcers

Tax audits happen and they can happen to you. If you get an audit letter, don't panic, but do make time to prepare. By following these guidelines, you can save yourself time, money and ulcers in getting through an IRS audit:



1. Answer all IRS requests before their deadline. If the IRS simply wants additional information, you can usually take care of this through the mail, solving the tax matter quickly and cheaply. By missing the response deadline, you expose yourself to closer scrutiny by the IRS.

2. Call your tax preparer. Your accountant has experience with IRS audit procedures and knows how to present the information requested by the IRS, and nothing more.

3. Gather your tax records. Organize and label all the records requested by the IRS for the audit. Be ready to explain these items, as well as provide documentation.

4. Don't automatically accept the agent's decision. If an error in your tax return is obvious, it's usually advisable to agree with the agent. However, if you believe that the agent has refused to consider a reasonable position, misinterpreted the tax code or over-assessed the deficiency, you can formally protest after refusing to sign a waiver agreeing to the proposed assessment. Again, your best option under these circumstances is to talk to your accountant before signing—or refusing to sign—a waiver.

5. Cool heads prevail. If there's a disagreement, don't argue with an IRS Agent. Unfortunately, our tax system works on a "presumption of correctness." Unlike our judicial system where you're innocent until proven guilty, the burden of proving you're correct or the IRS is wrong rests with you, the taxpayer. Explain your belief to the agent. If the agent persists in a questionable course of action, then contact the agent's immediate supervisor. While there's no guarantee the IRS supervisor will agree with you, most of them want to know about errant IRS agents. In any event, it is important to remember that the IRS wins about 80 percent of its litigated cases.

Some Final Thoughts

There are a few good business practices that can help in the event of an audit. Get a credit card used exclusively for business expenses; this eliminates the risk of losing receipts for cash purchases. Use a good computer-based accounting system (Quicken, QuickBooks, etc.) to record tax related transactions. And keep thorough records, receipts, canceled checks and bills in a filing cabinet, organized by year.

These simple practices can make an unexpected IRS audit end swiftly and with minimal pain. Like George Harrison sang in "Taxman," it can always be worse: "If 5 percent appears too small, be thankful I don't take it all."

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