MONEY MATTERS — Tax and financial planning strategies

IRS Red Flags: What cause an audit?

By Jacob Ansel

JUST THE THOUGHT OF AN IRS AUDIT is enough to send most peoples' blood boiling. We've all heard the horror stories. But there's actually a piece of very good news: the IRS audits only a little more than 1% of all individual tax returns, and that number falls much lower depending on your income and will shrink even lower thanks to budget cuts. According to the IRS Oversight Board, the IRS doesn't have the resources to pursue at least $30 billion worth of known taxes that are incorrectly reported or not paid. Does this mean you can get away with cheating on your taxes? Not quite. The IRS uses sophisticated computer algorithms to decide which returns to audit and if your return looks strange your chances of being audited go way up. So here are a few suggestions to minimize your chance of an audit.

Whether it's a personal or corporate audit, neither is fun and the process can last months. My best advice is to stay away from the red flags that trigger the IRS to take a second look at your tax return. Any corporate tax return with gross income over $10 million is manually entered into the system even if an electronic tax return is filed. If your return falls into this group, very careful categories of income, expenses, and balance sheet names should be maintained. Stay away from showing guest house expenses, for instance, and use rent expense since that's what it really is. If you pay an attorney to work on immigration related issues, use the expense category called professional or legal fees; don't call them immigration expenses. Using properly named categories reduces raised eyebrows. Make sure the return has all the required forms, check twice, and recheck.

The chances of being audited depends on many factors – income level, deductions claimed, the type of business you have – and while there's no sure way to avoid an audit, there are things to do to not draw attention to yourself.

There's a box to check on all corporate tax returns which notes if you filed any 1099-miscellaneous forms. If you check no, but still list professional fees, consulting fees, or outside contractors, this will pose a problem. On personal returns, make sure you file 1099 forms as there is a cross match between ID numbers and you can be sure if you pay someone not on your payroll without generating a 1099, an audit will follow.

According to the IRS, folks with an adjusted gross income greater than $1 million have a good chance of being audited. The IRS admits this, so why ever take a chance on a return? Double and triple check income, reported expenses, and line items. Make sure that all deposits into a personal bank account come from reported income. If you have other deposits from miscellaneous jobs or non-reported income, report it. Do you have every receipt and backup record for schedule A itemized deductions? If not, don't take the deduction because if you're audited all of your expenses will then be challenged. Contractors, restaurant owners, car wash and gas station owners are more likely to be audited thanks to the cash nature of their operations. The IRS keeps a keen eye on a business' description.

Reporting consistent losses on a personal return will likely cause an audit. IRS agents believe that those are hobby losses and not business losses. If your business loses money consistently for years, you should convert to a corporation since there's less of a chance you'll be audited. Claiming too many charitable donations also triggers a red light. The unwritten rule is that if you deduct more than 5% of income, the IRS will notice. If you have proof, there's nothing to worry about; if you don't, don't take the chance. Home office deductions claimed on a personal tax return is another red flag. I advise clients not to bother with this deduction. Find other items to write off; this one is too risky and often creates issues. Also, never use round numbers on a tax return. Consider the IRS agent looking at a return with income of $50,000 and deductions of exactly $20,000. That always is suspect.

Even if you take every precaution, theres no guarantee you won't be audited. The IRS randomly audits all types of returns. But if you are audited, don't try to talk your way out of it. Always have the proper backup, report all income, keep very good records for tax deductions and expenses, never inflate numbers, and go over every number on your return before signing off. ❑

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