

2017 IRS Nationwide Tax Forum

Tax Audits: Triggers and Tips

Are you really going to file that return?

An Audit Target!!

Learning Objectives

After completing this course, you will better understand and appreciated:

- How federal tax returns are selected for audit;
- Areas of higher scrutiny in an ongoing audit;
- Four areas of commonly audited large itemized or business deductions; and
- Relevance of whistleblowers, Suspicious Activity Reports, voluntary disclosures and amended tax returns.

Tax Audits

- FY 2016 – IRS processed over 244 million tax returns.
- FY 2016 – IRS audited nearly 1.2 million tax returns.
- 0.6 percent of all returns filed in CY 2015

Audit Roulette

Reality: Most income tax returns are not audited

- Audit Roulette:
- The Taxpayer's Mind –

The Guy down the street will do it.

Good for him: meet my friend the Special Agent

High Earners

Adjusted Gross Income	Returns Filed in Calendar Year 2015 (percent of total)	Examination Coverage in FY 2016 (percentage)
All returns	100	0.7
No adjusted gross income	1.7	3.25
\$1 under \$25,000	37.45	0.8
\$25,000 under \$50,000	23.21	0.49
\$50,000 under \$75,000	13.2	0.41
\$75,000 under \$100,000	8.52	0.52
\$100,000 under \$200,000	11.72	0.62
\$200,000 under \$500,000	3.38	1.01
\$500,000 under \$1,000,000	0.54	2.06
\$1,000,000 under \$5,000,000	0.25	4.6
\$5,000,000 under \$10,000,000	0.02	10.46
\$10,000,000 or more	0.01	18.79

Source: *Internal Revenue Service Data Book, 2016*, Publication 55B, Washington, DC, March 2017.

Unreported Form 1099 Income

- IRS Automated Underreporter Program
- Information reported matched to documents received
- Forms 1098, 1099, and W-2
- Forms 1099
 - 1099-C – Cancellation of Debt
 - 1099-K – Merchant Card and Third Party Network Payments
 - 1099-R – Distributions from Pensions, Annuities, Retirement Plans, IRAs, or Insurance Contracts
 - 1099-CAP- Changes in Corporate Control and Capital Structure
 - 1099-MISC – Miscellaneous Income

Alimony Deductions – IRC §§ 71, 215

- Matching issue of unreported alimony
- Errors claiming child support as deductible alimony
- Unreported property settlements

Large Itemized or Business Deductions

- Charitable contributions
 - The IRS knows your generosity based on your AGI
 - Keep adequate records
 - IRS Publication 4303 – Donor’s Guide to Vehicle Donation
 - IRS Publication 536 – Charitable Contributions
 - IRS Publication 561 – Determining the Value of Donated Property
- Home office deduction
 - Simplified Option – IRS Rev. Proc. 2013-13 or Regular Method
 - Regular and Exclusive Use
 - Principal Place of Your Business
 - Disallowed due to lack of need, exclusive use, or substantiation
 - IRS Publication 8829 – Business Use of Your Home
- Car and truck expenses
 - Deduct standard mileage or actual expenses, not both
 - Lack of adequate substantiation
- Meals and entertainment/travel
 - Excessive deductions without a business purpose, poor recordkeeping

Schedule C – Profit or Loss from Business (Sole Proprietorship)

- Audit risk increases as gross receipts rise

Under \$25,000	.9%
Under \$100,000	1.7%
Under \$200,000	2.2%

- Proper recordkeeping is crucial
 - Understand mileage deduction and log requirements
 - Business purpose for travel and entertainment
 - Separate checking account recommended
 - When records fail, use the *Cohan* rule (*Cohan v. Commissioner*, 39 F.2d 540 (2nd Cir. 1930))
- Unreported income may be problematic
 - Also true with LLCs (Form 1065), or S corporations (Form 1120S)

Hobbies, Horses, and Houses

- Hobby losses – IRC § 183
 - Losses limited to income from the hobby
 - Manner in which the activity is carried out
 - Expertise of the taxpayer; time and effort expended
 - Expectation to profit; history of income or loss
 - Elements of personal pleasure or recreation
- Rental losses – IRC § 469
 - Passive loss with limitations and phase-out
 - Unless qualified as a Real Estate Professional
 - 50% or more in real estate activities;
 - More than 750 hours in real estate activities; and
 - Materially participates in each rental activity (unless grouping election is filed)

Large Cash Purchases and Suspicious Activity

- FinCEN Form 8300 – Report of Cash Payments over \$10,000 Received in a Trade or Business
 - \$10,000 in one or more related transactions
 - Due within 15 days of receipt of the cash
 - Prior to 2012 automation, 200,000 paper forms filed annually
- Suspicious Activity Reports (SAR) and Suspicious Transaction Reports (STR)
 - Multiple or regular deposits under \$10,000
 - Can be illegal structuring - 31 U.S.C. § 5324

Referrals or Whistleblower Cases

- IRS Form 3949A – Information Referral
 - The angry former spouse
 - The angry relative
 - The angry co-worker or former employee
 - The angry neighbor
 - “Anonymous”
- IRS Form 211 – Application for Award for Original Information
 - If dispute exceeds \$2 million in tax, interest and penalties, a discretionary award of 15-30% may be granted
 - If under \$2 million, then a 15% award up to \$10 million may be granted

Domestic Voluntary Disclosure

- Underreported income or unfiled returns
- Not currently under audit or investigation
- Legal source income
- Some assurances against criminal investigation
- Income tax audit or brief review
- Probable reduction in penalties

Offshore Voluntary Disclosure

- Currently available to qualified taxpayers
- Streamlined process for non-willful taxpayers may be audited
 - No closing agreement
- Full OVDP will be audited
 - Formal closing agreement – IRS Form 906, Closing Agreement on Final Determination Covering Specific Matters

Amended Returns and Claims for Refund

- Frequency of audit
- Discriminate Inventory Function System (DIF) score
- Correct all errors
- Provide substantiation regarding changes

Return Preparer Investigations

- Abusive return preparer investigations
 - False refunds deposited into preparer's account
 - Overstated deductions to reduce tax liability of taxpayers
 - Many clients also examined
 - Tax is the liability of the taxpayer
 - Split of authority on interest as damages
 - Pick a return preparer carefully

Questions?