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.
• 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

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

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: 0.9%
  - 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?