THE WHITE PAPER

Your Guide to Life Planning

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Will You Be in the 1%? Surviving an IRS Audit

The IRS audited approximately 1.4 million individual tax returns filed in 2012.[1] That amounts to approximately 1% of 146 million individual returns filed that year. However, fewer than one-quarter of those audits involved face-to-face meetings with IRS auditors. The rest were conducted through the mail.

Filers earning less than $100,000 had a .58% chance of being audited. Among filers with income exceeding $200,000, the audit rate was 2.06%; for those earning more than $1 million, it climbed to 9.20%. Audit risk also increased for self-employed taxpayers who filed a Schedule C, Income and Expenses for sole proprietors. Depending on how much income was reported, the chance of being audited ranged from 1.0% for returns listing gross receipts under $25,000 to 2.7% for those reporting gross receipts of $200,000 or more.[1]

What Triggers an Audit

The following are some of the red flags that could alert the IRS, aside from earning a lot of money:

1. Running a cash business
2. Claiming the home-office deduction
3. Self-employment
4. Deducting business meals, travel, and entertainment
5. Failing to report all taxable income
6. Claiming 100% business use of a vehicle
7. Making large charitable contributions
8. Claiming a rental loss
9. Taking larger than usual deductions

What the IRS Looks For

Whether the IRS requests a face-to-face meeting or chooses to conduct its audit through correspondence, the following issues may arise:

- **Unreported income** -- The IRS will assess taxes on any "missing" amount plus interest and penalty charges -- regardless of whether the omission was accidental or intentional. A finding of significant fraud could even result in criminal prosecution and jail time.
- **Personal expenses vs. business expenses** -- Be prepared to prove that expenses you've claimed for business purposes were not actually personal expenses. Auditors pay particular attention to deductions related to entertainment, meals, travel, and transportation. If you own a business, keep all receipts and be ready to answer questions about the connection between each expense and your business.
- **Industry insights** -- Business owners should also keep in mind that the IRS has a Market Segment Specialization Program (MSSP) designed to train its employees about the intricacies of dozens of specific business niches, ranging from Alaskan commercial fishing to car washes and the scrap metal industry. Fortunately, the MSSPs Audit Technique Guides are available online (www.irs.gov; look under the "Businesses" heading), so you can check to see whether your industry is included in the program. If it is, studying the relevant guide might help you get inside the head of your auditor, so to speak.

Even if you don't expect the worst during your audit, there are several reasons it's still a good idea to enlist the services of an experienced tax professional to help you navigate the process. For example, a professional is probably more familiar with the complexities of ever-changing tax laws than you, and is also less likely to let emotions cloud his or her judgment. In addition, letting a pro speak on your behalf reduces the chance that you will accidentally volunteer information that could hurt your case.

This communication is not intended to provide tax advice and should not be treated as such. Each individual's tax situation is different. You should contact your tax professional to discuss your personal situation.

[1] *Source: IRS, Internal Revenue Service Data Book, March 2014.*

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