PERSPECTIVE

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IRS Audit Worries Grow

By Robert W. Wood

The Inflation Reduction Act is doling out nearly $80 billion in funding to the IRS. There has been considerable worry about how that money will be spent. The Wall Street Journal suggested that the money would fuel efforts to put the IRS into "beast mode." There have been even more extreme reactions, particularly to IRS plans to hire up to 87,000 new agents. In all, the meant-to-be-inflation buster law will dole out about $80 billion to the IRS for increased enforcement, operational improvements, customer service, and systems modernization.

That $80 billion is more than six times the current annual IRS budget of $12.6 billion. And while much of the money is to upgrade and improve systems and customer service, fear of increased audits is palpable. Of the overall funding, a whopping $45.6 billion is meant for enforcement, and enforcement means audits and collections. As a result, tax lawyers and accountants are likely to be fielding questions from clients about how all of this will shake out, and what it means for the next few years.

More audits means more talk about how audits are triggered, and about how to steer clear of them. How your facts and issues might stand up on audit are also logical questions for just about any taxpayer. Tax advisors are not supposed to play audit lottery or to base their substantive tax advice on statistics that show that most tax returns will never be examined. In other words, tax advice is supposed to ignore the indisputable fact that most tax returns are not audited.
In fact, when rendering a tax opinion, tax advisers are *required* by Treasury Department regulations to assume that every return *will* be audited. In truth, audit odds remain small, and that will likely continue even with all the new funding for the IRS. Besides, it will take time for the IRS to hire and train new employees, and to ramp up their systems. Tax opinion standards assume that there will be an audit. When I tell a client there is a 50/50 chance a tax deduction will be upheld, I mean there is a 50/50 chance assuming that it is examined and that the Internal Revenue Service or the courts will have to decide.

Because of these strict standards, it can be awkward to talk about audit risk. Yet no matter how sure you are of your return, you don't want to be audited, and there is nothing illegal or unethical about hoping to sail beneath the radar. You want to submit your tax returns and have them accepted without any fuss. Given how inconvenient and nerve-wracking any audit can be, it's only natural to worry.

This is especially true if you have a large income or a complicated tax return. There are many views about what will prevent or trigger an audit. But here are some relevant points, that are admittedly subjective. Every tax person probably has a list, and it may well change over time.

One precaution is to be sure to report Each Form 1099 and each K-1. This seems obvious, but still trips up many people. All Forms 1099 and K-1 are linked to your Social Security Number. Don't ignore them. If you disagree with the amount or nature of a payment, you'll need to explain it. Talk to a professional about the best way to do that on your facts.

Another idea is to try to steer clear of Schedule C, if you legitimately can. Schedule C is where proprietors are supposed to report their income. IRS statistics show that this schedule is one of the most likely types of returns (it is really a part of a return) to be examined. It is what you file if you operate a small business that is not in a legal entity (such as a corporation, LLC or partnership).

Examples are little enterprises that you run from your garage, on the internet, or on weekends, even though the bulk of your income may come from wages from your regular job. Schedule C is also the primary place the IRS can audit "hobby" activities that you claim are a business but that the IRS says is really a hobby. That is about claiming business losses, which the IRS may say are not business related at all. Be especially wary if you have several years of losses in a row.

How about charitable contributions? There is nothing wrong with making them and deducting them. In fact, being charitably minded is admirable. But consider how you want to donate, and what kind of support you have. In particular, use care with noncash charitable donations. I'm talking about bitcoin, real estate, easements, nonpublic stock, you name it. If you make noncash donations, scrupulously follow the forms, including Form 8283 – which is linked to appraisal requirements. Don't get too greedy with valuations, and expect scrutiny, especially on large contributions.

Wage vs. nonwage distinctions can matter too. If you own an S corporation, make sure that the company pays you a fair wage for what you do. Wages are subject to employment taxes. This is the flip side of the "reasonable compensation" issue for C corporations. With a C corporation, the IRS may criticize you for paying *too much* in compensation on a deductible basis. There, the IRS may say some payments are nondeductible dividends.

With an S corporation it is the reverse. Long ago, this issue came up with former Senator John Edwards and with Newt Gingrich. In each case, the candidate was criticized for having an S corporation he owned paying out small amounts as wages with the lion's share of the earnings distributed as dividends. What was at stake for Edwards and Gingrich was the additional payroll taxes they would have borne had their company paid out the entire amount as salary or bonus.

A dispute of this sort primarily involves what is reasonable compensation for services rendered, and the IRS looks at this issue in earnest. More generally, now that the IRS has a special form for independent contractor pay, IRS Form 1099-NEC, you should expect more scrutiny about self-employment tax too. Self-employment tax amounts to both halves of employment taxes, and depending on amounts, can add as much as 15.3% to your tax bill.

Another thing to watch is real estate losses, farming losses, etc. If you have rental real estate, lose money and offset your losses against other income, expect scrutiny. Keep especially good records of how much time you spent on the real estate activities, since that can influence whether your losses are active or passive.

Excessive mean and travel deductions can stick out too. Even if your income is high, consider if you really meet the business purpose tests. Is the number of audits increasing?

Yes, but that doesn't mean you will be audited. Audit rates are still small no matter what your income.

If you are audited, you will generally need to provide receipts and other supporting information when the IRS asks. Sometimes, there will be a series of back and forth by correspondence on what the IRS calls IDRs, Information Document Requests. Some audits involve a physical appointment or visit, but many are done entirely by correspondence. In some cases, the IRS likes to interview the taxpayer.

For a whole variety of reasons, you are usually better off hiring a professional to handle your audit, rather than trying to do it yourself. How the audit is handled is important, and the risks of direct interaction with the IRS can be significant. You may say too much, too little, or unintentionally misspeak. Criminal tax cases are rare, but some of them arise when the IRS believes that there was evasion or obstruction during the tax audit itself.

At the same time, if you have a tax opinion from your attorney that is protected by attorney client privilege, you should not have to provide it. You don't want to hand the IRS a roadmap of arguments to make against you. On these and many other points, it can pay to get some tax advice.

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