IRS FOCUSED ON BUSINESSES, ESPECIALLY SOLE PRORIETORSHIPS
Learn how to avoid triggering audit, how to deal if you do

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As a business owner and as an individual, there are various types of IRS audits that you may face. While an audit notice from the IRS is often intimidating, it is important for you to understand what triggers audits, the types of audits and your rights in addressing an audit.

What Triggers an Audit?

The IRS is very focused on auditing businesses. The IRS has trained specialists for reviewing specific business issues and market segments, from shareholder loans, executive compensation and partnerships to attorneys and the construction industry.

In addition to the specialization programs, the IRS is very focused on auditing business owners doing business as sole proprietors (filing Schedule C) and returns with issues pertaining real estate ownership (Schedule E). Business owners should be prepared for the IRS to review all of their bank statements to determine if all income has properly been accounted for on the return. The cost and improvement of capital assets will also likely need to be verified as to depreciation.

A common audit trigger occurs when information reported to the IRS about you or your business does not match what you put on your return. The IRS matches the 1099's and W-2's it receives from employers, contractors, vendors and banks to what is on your return. Discrepancies in the document matching process will cause audits.

The IRS also audits tax returns with deductions that are not in sync with reality. For example, a return showing a large deduction for charitable contributions that appears to be financially impossible based on the income reported on the return will likely get questioned by the IRS. This could then lead the IRS into other issues on the return.

Types of Audits

There are a number of types of audits, ranging from the simple Letter Audit to the very complex Field Audit interview conducted in your home or office.

Letter Audits

If the IRS believes that not all income has been reported your return by its document matching process, a letter will be issued for an explanation. Mathematical errors and omitting necessary schedules will also cause the IRS to question the return. Letter Audits can be resolved with an explanation of any discrepancy and appropriate documentation. If your explanation is not accepted, the IRS will issue a Notice of Deficiency. This notice gives you the right to dispute the audit in court.

Timely responding to IRS correspondence is important; if you do not respond or go to court, the IRS will find that you owe the tax and commence collecting it.

Audits at an IRS Office

Audits at the IRS begin with a request for a meeting at a specific time and date at an IRS office. The IRS will list documents to bring to the meeting, which puts you on notice of the issues the IRS has identified for investigation. You have the right to have an authorized representative bring your records and meet with the IRS on your behalf.

Deductions for the business use of personal items are a favorite IRS subject. The IRS will usually request verification of the claimed business use of a personal vehicle. The IRS will generally need a listing of the business purpose of each mile driven. Entertainment expenses get attention, as do moving expenses. Other inquiries could involve verification of payments of subcontractor labor, cost of goods sold and the cost of capital equipment.

The IRS usually starts an audit one year at a time. If an issue is developed on one year, the IRS can request to open up the same issue on prior years' returns. In most situations, the IRS must complete an audit within three years from the date a return is filed or they will be barred from making any changes.

Field Audits in Your Office of Home

The IRS also requests audits at your office (for business audits) or home (for personal audits). The IRS agents will review bank statements for a reconciliation of the income reported on your return and deposited into your account. If the IRS finds more money in your account than on your return, you will have to explain why the excess should not be considered taxable income. The IRS can also find that you made more than you reported by analyzing changes in your net worth or finding increased expenditures and costs of living (presuming that if you are spending it, you are making it).

Your Rights in Addressing an Audit

Audits at any level are best addressed as soon as possible. You have the right to legal representation and the audit can be conducted at the office of your attorney or CPA. If you retain a professional to represent you, any IRS interactions or contacts are required to be routed through your representative.

It is important to know that you have the right to appeal at every level of IRS audits, including the right to have your attorney go to U.S. Tax Court to have an impartial hearing on the audit. The Tax Court judges are based in Washington, D.C. and travel the U.S., coming to the Greater Cincinnati area approximately 1-2 times per year to conduct trials and hearings.

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