

Avoiding an IRS Tax Audit

By Kevin J. Bassett, CPA

The IRS audit rate has tripled since 2008 for some types of tax returns. Depending on income, between 1% and 10% of individual income tax returns were selected for audit. Business audit rates ranged from 1% to 18%. Our audit defense team has also seen an uptick in audits and has received a record number of cases referred to our firm. While we win the majority of our audits, we believe the best approach is to try to avoid a tax audit in the first place.

Here are some strategies to reduce your risk of an IRS audit:

Avoid filing Schedule-C for your business

Any attorney will tell you it's dangerous to operate your business as sole proprietorship. It also triples your IRS audit risk. If you incorporate or form an LLC you will increase your legal protection, lower your audit risk and probably save self-employment taxes. Since single member LLCs are reported on Schedule-C, you should add a second partner. This will allow you to file a separate tax return and reduce your audit risk.

Properly report vehicles

Many tax returns are selected for audit simply because they did not properly complete the vehicle disclosures. All business vehicles need to be reported on Form 4562 with complete mileage and personal usage disclosures. IRS agents also scrutinize returns that claim a 100% business deduction for all vehicles. Agents are expecting to see at least some personal use, of the owner's vehicle. Make sure this personal use is reported on Form 4562 and the owner's W-2.

Report all 1099 income

Unreported income is another common source of IRS audits. If you, or your business, receives 1099 income, it needs to be reported (be sure to match tax ID numbers). Sometimes, when a business incorporates, the owner still receives 1099s with a personal social security number from long-time customers. Make sure this income is reported on the owner's personal return. Also, watch out for missing and amended 1099s from your broker.

Minimize miscellaneous itemized deductions

Miscellaneous itemized deductions include employee business expenses, investment expenses and other deductions. These expenses are only deductible to the extent they exceed 2% of your AGI, and they increase your audit risk. Take these deductions on a business tax return if possible. If you are an employee, convince your employer to restructure your compensation to accommodate these expenditures as tax-free reimbursements.

File an extension

Many practitioners have maintained that the audit rate has been lower for extended tax returns. Although there is no published IRS statistics on this matter, our own data supports this. Our data suggests that tax returns filed in the months of June and July have the lowest IRS audit selection percentage. While this certainly did not eliminate audit risk, it's worth considering.

In addition to reducing your audit risk, make sure you keep good books and records for at least 3 years from your tax filing date (longer in some states). Also, make sure you get professional representation if you get selected for audit. An experienced professional will limit the scope of the audit and present your case in the best light possible. In most cases they can prevent you from ever meeting the agent. You have other things to do with your life than hang out with an IRS agent.

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