Audits

Tate's Tax Service
Est. 1956

Representation

Individual taxpayers who are under audit by the IRS may attend the audit in person without any assistance from a tax professional. However, this can be a dangerous mistake. Although not officially stated, it is the job of an IRS Revenue Agent to conduct an audit with an eye toward finding additional tax owed. With so many gray areas in tax law, and considering the tax code's complexity, an individual who chooses to go it alone is a sitting duck. Without extensive tax education and experience, the examiner can (and sometimes will) say anything to find additional tax due on the return. Without the necessary knowledge, the taxpayer is powerless to refute the agent's rationale.

Selection of Returns for Examination

Search for Unreported Income

The IRS performs matching functions to reconcile information reported on Forms 1099 and W-2 with information reported on the taxpayer's return. If income reported by the taxpayer does not meet or exceed amounts reported to the IRS, the taxpayer will receive either a bill for tax on the difference or an audit notice.

Worker Reclassification Efforts

The IRS conducts joint employment audits with state tax agencies to determine whether workers classified as independent contractors are in fact employees. One initiative looks at employers who issue both Forms 1099 and W-2 to the same employee in the same year, while a second examines employers issuing more than five 1099-MISC forms exceeding $25,000 each to contractors with no other source of income.

Schedule C, *Profit or Loss From Business*

Issues associated with sole proprietorships are common audit triggers. The IRS has several approaches to achieve an increase in income tax, as well as the assessment of self-employment tax.

- ***Unreported income.*** There is a relatively high potential for unreported income from cash transactions with sole proprietorships. The IRS will examine the taxpayer's bank records to detect deposits that are unaccounted for, compare revenue and expenses of similar businesses, and in some cases will perform a "lifestyle" audit to reconstruct income based on changes in the sole proprietor's net worth based on valuation of assets.
- ***Losses.*** Significant losses reported on Schedule C, or losses continuing over two or more years, may increase the chance of audit. If the IRS is successful in reclassifying an activity as a hobby instead of a for-profit business, losses will be disallowed.
- ***Bartering.*** The fair market value of products and services received through bartering can be considered business income if the products or services rendered are associated with the sole proprietorship. If the sole proprietor trades through a barter exchange program, the program will issue Form 1099-B, *Proceeds from Broker and Barter Exchange Transactions.*

Audit Procedures

Soft Notice

The IRS uses the Automated Underreporter (AUR) Soft Notice to encourage taxpayers to self-correct income reporting with minimal burden and resources. Notice CP 2057 is issued to certain taxpayers with apparent

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underreported income. The form informs the taxpayer that there appears to be a discrepancy with the income types listed but does not provide them with any type of calculations. It instructs the taxpayer to file a Form 1040X to correct their return if the information shown on the notice is correct. The IRS does not directly follow up these notices but taxpayers that repeat their behavior will be identified in the following tax year.

Examination by Mail

The taxpayer receives Notice CP 2000 from the IRS disclosing proposed changes. The taxpayer typically has 30 days to respond and has three options to the IRS proposals.

- To agree with all the proposals.
- To partially agree with the changes.
- To dispute all the changes proposed by the IRS.

The taxpayer is allowed to sign an authorization that enables another party to represent him or her in connection with the Notice CP 2000. The authorization is part of Notice CP 2000, and a separate power of attorney is not required.

Field Audit

The revenue agent will send a letter to the taxpayer requesting that the taxpayer phone the agent. At that time, the date, location, and agenda for the first meeting will be set. The taxpayer has the right to request that the examination take place at a reasonable time and place that is convenient for both the taxpayer and the IRS.

Audit Strategy

The best way to prepare for an audit is to put oneself into the auditor's shoes. Take the perspective that you are looking for anything possible to increase the tax liability on the return. This is an area where a qualified tax preparer can be invaluable.

Pose tough questions and "throw out" any questionable deductions. Make sure any issue raised during an audit is something that has already been considered. If the pre-audit function is performed properly, the actual audit will be more comfortable, and you will be prepared for any negative adjustments.

Audit Video

The IRS has created a video web page to assist taxpayers preparing for a small business audit. Go to the IRS website at www.irsvideos.gov/audit.

Requesting a Different Auditor

A taxpayer or taxpayer's representative has the right to request a different auditor if the current one seems uncooperative, too busy, or too inexperienced to properly consider the issues under examination. The request should be made to the auditor's supervisor by phone or in writing and should include a detailed explanation of the reasons for the request.

Take It Seriously

Any comments made to an IRS employee that could be interpreted as a threat against the employee will be taken seriously and fully investigated. Do not to joke around with IRS employees during an examination.

Repeat Examinations

If a return was examined for the same items in either of the two previous years, and no change was proposed to the tax liability, contact the IRS immediately and the examination will likely be discontinued. This policy is in accordance with IRC section 7605(b), which states that no taxpayer shall be subjected to "unnecessary examinations."

Contact Us

There are many events that occur during the year that can affect your tax situation. Preparation of your tax return involves summarizing transactions and events that occurred during the prior year. In most situations, treatment is firmly established at the time the transaction occurs. However, negative tax effects can be avoided by proper planning. Please contact us in advance if you have questions about the tax effects of a transaction or event, including the following:

- Pension or IRA distributions.
- Significant change in income or deductions.
- Job change.
- Marriage.
- Attainment of age 59½ or 70½.
- Sale or purchase of a business.
- Sale or purchase of a residence or other real estate.
- Retirement.
- Notice from IRS or other revenue department.
- Divorce or separation.
- Self-employment.
- Charitable contributions of property in excess of $5,000.

This brochure contains general information for taxpayers and should not be relied upon as the only source of authority. Taxpayers should seek professional tax advice for more information.

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