

Advice on Internal Revenue Service Audits

With the internal Revenue Service (IRS) making headlines lately about increasing audits, it is important to do what you can to avoid being audited. Keep in mind that having to pay more money is not the only unpleasant part of an IRS audit. Typically, audits are a time consuming and aggravating process. Being audited by the IRS isn't like a criminal trial where someone is presumed to be innocent; the burden of proof lies on a taxpayer to prove they are innocent and filed an accurate tax return.

It is important to remember that the IRS computer systems select the returns that are to be audited. No human ever reviews the returns until they are selected for an audit by the computer system that determines returns likely to yield the most money to the government. It makes this decision by reviewing returns for "red flag" characteristics. Red flag characteristics are those income, deduction, and credit types that have historically seen the most imprecise calculations and abuse by taxpayers.

A taxpayer is more likely to get audited if he or she generates income from any source other than regular employment wages. Statistics show that someone who files Form 1099 are up to three times more likely to receive an audit than a person who only files Form 1040. A 1997 IRS press release claimed more than three percent of taxpayers filing Form 1099 reporting between \$25,000 and \$50,000 of income were audited, compared with under one percent of 1040 returns that were audited.

The IRS offers hundreds of possible deductions and credits to help taxpayers lower their income tax liability, but taking an excessively large amount will send a very clear red flag to the IRS. But how does a taxpayer know what's excessive? That is a tricky question to answer as there is no all-applying rule because the IRS determines the allowable number of deductions for a taxpayer mostly based on their income.

Although there are many tax laws allowing self-employed individuals to lower their liabilities by using home office deductions, taxpayers taking home office deductions are probably the most frequently contested by IRS because they are easy for a taxpayer to bend the truth on. In order to claim a home office deduction, a taxpayer's home office must be the principal place of business. This means they perform most of their work in the home office. Also, the space must be used exclusively for running the business and not for personal use as well. Otherwise the space cannot be considered a home office and may not be deducted.

Losses from a business can also be another red flag for the IRS. If an individual starts their own businesses for the purpose of generating excessive tax deductions, the IRS will catch on quickly. Businesses must be profitable in at least three of the past five years in order to be considered a legitimate business for tax purposes. Otherwise the IRS will realize the business is functioning as a tax shelter.

If there are big inconsistencies between your previous tax returns and your current return then you could be sending a red flag to the IRS. The most common examples are name changes (i.e. your name or the name of one of your dependents), claiming new deductions and credits, or a significant change in income. For example, if a taxpayer earned \$75,000 one year, then only \$15,000 the next, the IRS is going to wonder what happened.

If there are differences in the income you reported to your state treasury and to the IRS, then the IRS will investigate as to why the information reported is inconsistent. Not only do federal and state authorities receive records of all sources of income and financial information for every taxpayer – the IRS does as well. If they notice any errors that point to misrepresentation of income then you can expect to receive a letter informing you of an audit.

If your tax returns are incomplete or sloppily prepared then this might also get the attention of the IRS. If there are blanks where there should be numbers or if most of the numbers you claim are round numbers (like \$2,500 or \$10,000) then this will also send up a red flag to the IRS.

About the Author

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