

The Audit Process, Recordkeeping and Your Taxpayer Rights

An important fact to have firmly in mind as you approach your record keeping and documentation is that IRS audits occur generally 12 to 18 months *after* the end of the tax year being audited. You can very easily be in the position of having an IRS agent ask you detailed questions on a business meal, travel expense or other deduction that happened over two years ago!

Simple mistakes can cause a return to be questioned. These mistakes and oversights can include:

- ✓ Mathematical errors – Simple, you didn't add or subtract correctly!
- ✓ Not attaching required forms, such as W-2's and 1099's with withholding tax
- ✓ Income that was independently reported to the IRS and that its computers couldn't find on your tax return - These can be 1099s and W-2s that the IRS computer scans and cannot match on your return. Sometimes the IRS is correct sometimes it is not.
- ✓ Social security number and name do not match - The IRS now matches the first 3 characters of all last names against the individual's social security number using the Social Security Administration database. When there isn't a match between the name and social security number you are sent a letter.

How is a return typically selected for audit? The IRS subjects all personal income tax returns to a computerized analysis based on a mathematical technique known as Discriminate Function (DIF), which identifies income tax returns with a high probability of error and a chance of significant tax change. The DIF program evolved from a concern during the 1960s that too many "no change" audits were occurring, and that IRS audits should focus on returns likely to have errors. Under the DIF procedure, returns with high DIF scores or other special features are manually inspected to select some for audit. Thus, the DIF score acts as a red flag for IRS audits. The DIF formula is secret, known to only a very few senior IRS officials. Experience indicates that certain factors are likely to increase the DIF score and the possibility of an audit. Among these factors are high salaries or other compensation, high expenses relative to income, and the presence of certain types of deductions such as charitable contributions and medical expenses. DIF formula data is developed from a range of sources, including IRS audit experience. Unfortunately for many of the readers of this book, self-employed individuals are usually at the top of the IRS's "most audited" list.

Your business code can also subject you to audit. As you can see on our sample returns there is a box for an industry code on your schedule C (box B at the top of the form). This code identifies to the IRS the type of business you are in. Some IRS auditing is being done centering around this code rather than on the actual numbers on the return. In other words, the IRS in your district may be looking into "independent artists, writers & performers" code 711510, and your return could get chosen for a full-blown audit, regardless of your DIF score.

Your audit might be caused by having the wrong preparer. If, in the course of doing audits the Internal Revenue Service notices certain patterns of abuse or incompetence from a tax preparer then they might decide to target taxpayers who used that particular preparer.

The DIF score is just the first stage of the potential audit process. Once the return is flagged, an IRS examiner will review it to see if he or she thinks it is worth auditing, and if they have the time to perform the audit. This same IRS agent is generally the one who decides if your return will actually be audited. If the amounts “flagged” on your return just concern one or two line items, it may be subjected to a “desk audit,” which causes you to get a letter asking for substantiation or detail on a particular line item on the return. This type of audit is all done via mail. The taxpayer sends in the supporting documentation, the agent reviews it, and if there are no further questions, the agent lets you know the result.

The second type of audit is of the live and in-person kind. Usually the IRS will ask you to come into their office bringing all your supporting documentation. In some instances, if the audit is big enough, they may choose to visit your place of business (virtually all LLC, Partnership or Corporate audits are “in person”). The audit notification will tell you in advance exactly what type of documentation is wanted and what line items on the return are being examined. The IRS does not allow the auditor to turn the audit into what we call a “fishing expedition.”

The audit can be conducted with the taxpayer and/or with an authorized representative such as a CPA, Attorney or Enrolled Agent. The taxpayer may bring a professional with him or her.

Audits are very times consuming in preparation but usually fairly straightforward affairs once they begin, they start with a detailed interview. The interview helps to develop a profile of you, your business and the manner in which you operate your business. You will also be asked questions about your finances as they relate to your tax return.

The audit process in some ways is fairly simple: The auditor points to a line on the tax return and asks for all the substantiating documents for that number. For instance, if you are self-employed the agent might ask you for copies of all your bank statements. The agent will add up all your bank deposits for the year and compare them to your total gross income on your Schedule C form. If your Schedule C form says that your gross income was \$50,000 and you, in fact, deposited \$75,000 in your bank accounts during the year you’d better be ready to do some explaining!

If you accept credit cards or online payments with services such as PayPal the agent will ask for independent reports of that activity. The IRS has just implemented (for 2011) the new Form 1099-K for reporting payments made to you by credit and debit cards. Starting in 2011 banks and other payment settlement services will need to report gross annual receipts on Form 1099-K (the 1099-K will not be required if your receipts are less than \$20,000 or total number of transaction are less than 200).

Substantiation for expenses and deductions usually means producing 2 documents; the actual receipts *and* proof of payment in the form of a cancelled check or credit card statement. The IRS does not as a rule accept canceled checks or credit card statements as receipts (though some auditors will in practice, especially when the taxpayer has noted the specifics of the expense on the memo section of the check or on the credit card receipt). The other hurdle is that you will be asked to explain the nature of the expense or deduction. In other words how and why is that deduction an “ordinary and necessary” expense of your profession?

On a recent Internal Revenue Service audit I had a well-known writer who had to explain a research related travel deduction for her latest book. In this case she had all the receipts and printed e-mails for the trip, but she then had to open her book and discuss with the agent the relationship between specific passages in her book and the trip in question.

Let’s take some examples of the more contentious and difficult areas and see how they might play out during an audit:

1. Meals & Entertainment expense – while we know that meals & entertainment are only 50% deductible, they are still a real audit target for the IRS. First the agent will want to see a list of all the meals for the year by amount. This list must equal the total amount of meals that has been put on the tax return and must include the “who, what & where” detail. You should bring your schedule book/diary with your notations for each meal to the audit so when the agent wants substantiation you can show him or her your entry and explain the reason for the deduction. If the situation was a travel related and you used the government per diem rates, the agent will ask you about the trip itself. Be ready to talk to the agent about your profession to help justify this deduction, to show why this trip and/or this meal it was “ordinary and necessary.” If the trip is deductible, the meals are as well. The agent might ask to look at contracts for specific jobs to make sure that the employer was not reimbursing for your meals expense.
2. Travel – the agent will want to know what the business purpose was. The less defined and flabbier your argument is, the more likely the agent is to disallow the deduction.
3. Mileage – The agent will want to see a listing of total mileage for business use for the year, which includes a line item for each trip, an estimate of miles driven, and a note what the business purpose was. Though the IRS likes odometer readings it does not require them. It is my experience that a reasonable round trip estimate will usually suffice. It is the business purpose that is most important. Most items on your list will probably be straightforward, such as trips to your clients office or to a job site, but the agent might select a few to ask you about specifically. Obviously, the more business miles you write off the more it is likely that the agent will question trips.

MSSP – The IRS Audit Training Manuals

It surprises many folks to learn that the IRS actually publishes its training manuals concerning audits, part of its “Market Segment Specialization Program.” These manuals can be downloaded from our website – www.artstaxinfo.com, and are absolutely indispensable guides. Many industries are covered by these manuals.

Audit Etiquette

Most IRS agents who I have dealt with are generally fair and reasonable people. This is not to say that you will not have arguments and subsequent appeals but many issues can be settled on the agent’s level. The formal appeals process is very time consuming and you want to avoid this if possible; always try to settle your audit on the agent level. Characteristically IRS agents are classic bureaucrats: they want to process your audit and get it off their desks as soon as possible. That being said I have had a number of audits recently where the agent seemed to enjoy learning about the taxpayer’s profession. I had a Broadway producer showing an agent cast photos and playbills from her shows, a musician showing the agent pictures of his many instruments and offering to play them for him if he wanted to come to his studio. These conversations helped create a sympathetic relationship with the agents that defiantly helped in the audit process.

One thing that I cannot state too strongly, audits are VERY time-consuming, there is no way around that. I have not been involved in any audit that has not taken the taxpayer many hours of preparation.

Here are some other pointers:

1. Be fully prepared with details on only the item the agent requested, and no more. Do not bring anything extra to the audit. Answer questions as simply and honestly as you can, explaining the nature and the reason for the deduction and with no unnecessary embellishment.

In the long run you will benefit if you give detailed and complete information and are forthcoming in your answers. Approaching the audit this way will often keep the agent from delving deeper into the return. I liken IRS agents to thieves looking for a car with the keys still in the ignition. If you give the agent the feeling right off the bat that you have your act together and are fully prepared, it can have the effect of taking the agent off his or her guard. While you do not want to be overly friendly you do want to try and develop a certain warmth and openness with the agent.

For instance, if one of the audit items is car mileage and you provide a neatly typed list outlining each trip, the miles driven, and the business purpose, the agent might not ask any specific questions, but simply take a copy of the list for his or her files. You would follow the same procedure

for all the questioned items: have a list of each deduction, including amounts and description, to give the agent. Receipts and proof of payment should accompany each list. From a voluminous list, the agent might just pick a few receipts to “audit” or review.

2. An old canard suggests bringing in messy receipts and “letting them do the work,” this is a fools advice. You should appear as neat and be as forthcoming as possible. Incidents have been reported of the agent being given less than complete records and receipts, but because the package was so neat and orderly, he or she assumed it was complete and didn’t even review the package!
3. Never cop an attitude or try to “snow” the agent in any way! I know quite a few IRS agents and, believe me; they have seen and heard it all. Treat the experience as a task (however unpleasant) that has to be worked through. Treat the agent with respect and courtesy and make sure your tax professional does the same. Try to settle matters on the agent level. If you ultimately need to fight something, that’s OK, just don’t make it a first impulse.
4. **NEVER** go to any audit without a tax professional. As a tax professional I only have the taxpayer present if I feel the taxpayer is the best one to answer the larger questions relating to their business. A lot of responses to auditor questions do rely on some judicious “spin-doctoring” though.

I don’t necessarily try to “make friends” with the agent. At its core it is an adversarial relationship. A measure of cordial respectfulness is best. Without being bellicose I always want the agent to know we will fight if necessary, but we rather not.

Develop a strategy with your tax professional before you even meet with the agent and assess your weaknesses and strengths. By going to an audit with a strategy the process is less likely that will get out of control. Your tax professional may see from the outset the course the audit might follow.

Recordkeeping

We have discussed record keeping throughout the book without addressing how to actually do it. Our Website at www.artstaxinfo.com has some very handy and easy to use Microsoft® Excel® downloadable worksheets for simple organization of income and expenses throughout the year.

There are also several accounting programs for this purpose and I can recommend three that I like, and list the Websites where you can get some additional information on each one:

1. Quicken®– www.quicken.intuit.com
2. Mint®- a cloud based program, great for those that travel www.mint.com

3. QuickBooks® – www.quickbooks.intuit.com (for those needing more advanced accounting features), Quickbooks also has a great cloud based service, Quickbooks Online www.quickbooksonline.intuit.com

Once these programs are set up properly, they do a great job and are easy to operate; they will be an enormous help at year-end. Purchase an accordion files at an office supply store to keep your receipts in, or buy a receipt-scanner to keep the information digitally (be sure to backup, you will have to print these receipts if you get audited, the agent is NOT going to sit and look at your computer screen). Remember I have great free worksheets available on www.artstaxinfo.com as printable forms and Microsoft® Excel® downloadable worksheets. These spreadsheets are easy to customize and keep with you throughout the year to track your income and expenses.

Consider hiring a good bookkeeper if you are too busy in your professional life to do the record keeping. Bookkeeping help is relatively inexpensive and can save you a world of headaches.

One last note on record keeping, while you may live in the digital world, doing your accounting in Mint® on your iPad® and recording your notes and keeping your schedule on your smartphone, keeping and preparing your documents in the cloud that is NOT the world of the Internal Revenue Service! When you are audited, as I tell my clients, you are back in 1957; it is a paper, hard copy world. Keep this in mind, print and/or backup often and safely so you have all notes and records for at least 3 years incase Uncle Sam comes calling.

Your Rights as a Taxpayer

Several years ago the IRS created a publication that explains your rights as a taxpayer. It includes an eight-part “Declaration of Taxpayer Rights,” as well as a section on audits, appeals, collections and refunds. Here is the text of Publication 1:

DECLARATION OF TAXPAYER RIGHTS

I. PROTECTION OF YOUR RIGHTS

IRS employees will explain and protect your rights as a taxpayer throughout your contact with us.

II. PRIVACY AND CONFIDENTIALITY

The IRS will not disclose to anyone the information you give us, except as authorized by law. You have the right to know why we are asking you for information, how we will use it, and what happens if you do not provide requested information.

III. PROFESSIONAL AND COURTEOUS SERVICE

If you believe that an IRS employee has not treated you in a professional, fair, and courteous manner, you should tell that employee's supervisor. If the supervisor's response is not satisfactory, you should write to the IRS director for your area or the center where you file your return.

IV. REPRESENTATION

You may either represent yourself or, with proper written authorization, have someone else represent you in your place. Your representative must be a person

allowed to practice before the IRS, such as an attorney, certified public accountant, or enrolled agent. If you are in an interview and ask to consult such a person, then we must stop and reschedule the interview in most cases.

You can have someone accompany you at an interview. You may make sound recordings of any meetings with our examination, appeal, or collection personnel, provided you tell us in writing 10 days before the meeting.

V. PAYMENT OF ONLY THE CORRECT AMOUNT OF TAX

You are responsible for paying only the correct amount of tax due under the law--no more, no less. If you cannot pay all of your tax when it is due, you may be able to make monthly installment payments.

VI. HELP WITH UNRESOLVED TAX PROBLEMS

The Taxpayer Advocate Service can help you if you have tried unsuccessfully to resolve a problem with the IRS. Your local Taxpayer Advocate can offer you special help if you have a significant hardship as a result of a tax problem. For more information, call toll free 1-877-777-4778 (1-800-829-4059 for TTY/TDD) or write to the Taxpayer Advocate at the IRS office that last contacted you.

VII. APPEALS AND JUDICIAL REVIEW

If you disagree with us about the amount of your tax liability or certain collection actions, you have the right to ask the Appeals Office to review your case. You may ask a court to review your case.

VIII. RELIEF FROM CERTAIN PENALTIES AND INTEREST

The IRS will waive penalties when allowed by law if you can show you acted reasonably and in good faith or relied on the incorrect advice of an IRS employee. We will waive interest that is the result of certain errors or delays caused by an IRS employee.

EXAMINATIONS, APPEALS, COLLECTIONS, AND REFUNDS

EXAMINATIONS (AUDITS)

We accept most taxpayers' returns as valid. If we inquire about your return or select it for examination, it does not suggest that you are dishonest. The inquiry or examination may or may not result in more tax. We may close your case without change; or, you may receive a refund.

The process of selecting a return for examination usually begins in one of two ways. First, we use computer programs to identify returns that may have incorrect amounts. These programs may be based on information returns, such as Forms 1099 and W-2, on studies of past examinations, or on certain issues identified by compliance projects. Second, we use information from outside sources that indicates that a return may have incorrect amounts. These sources may include newspapers, public records, and individuals. If we determine that the information is accurate and reliable, we may use it to select a return for examination.

Publication 556, Examination of Returns, Appeal Rights, and Claims for Refund, explains the rules and procedures that we follow in examinations. The following sections give an overview of how we conduct examinations.

By Mail

We handle many examinations and inquiries by mail. We will send you a letter with either a request for more information or a reason why we believe a change to your return may be needed. You can respond by mail or you can request a

personal interview with an examiner. If you mail us the requested information or provide an explanation, we may or may not agree with you, and we will explain the reasons for any changes. Please do not hesitate to write to us about anything you do not understand.

By Interview

If we notify you that we will conduct your examination through a personal interview, or you request such an interview, you have the right to ask that the examination take place at a reasonable time and place that is convenient for both you and the IRS. If our examiner proposes any changes to your return, he or she will explain the reasons for the changes. If you do not agree with these changes, you can meet with the examiner's supervisor.

Repeat Examinations

If we examined your return for the same items in either of the 2 previous years and proposed no change to your tax liability, please contact us as soon as possible so we can see if we should discontinue the examination.

APPEALS

*If you do not agree with the examiner's proposed changes, you can appeal them to the Appeals Office of IRS. Most differences can be settled without expensive and time-consuming court trials. Your appeal rights are explained in detail in both Publication 5, *Your Appeal Rights and How To Prepare a Protest If You Don't Agree*, and Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refund*.*

If you do not wish to use the Appeals Office or disagree with its findings, you may be able to take your case to the U.S. Tax Court, U.S. Court of Federal Claims, or the U.S. District Court where you live. If you take your case to court, the IRS will have the burden of proving certain facts if you kept adequate records to show your tax liability, cooperated with the IRS, and meet certain other conditions. If the court agrees with you on most issues in your case and finds that our position was largely unjustified, you may be able to recover some of your administrative and litigation costs. You will not be eligible to recover these costs unless you tried to resolve your case administratively; including going through the appeals system, and you gave us the information necessary to resolve the case.

COLLECTIONS

*Publication 594, *The IRS Collection Process*, explains your rights and responsibilities regarding payment of federal taxes. It describes:*

- What to do when you owe taxes. It describes what to do if you get a tax bill and what to do if you think your bill is wrong. It also covers making installment payments, delaying collection action, and submitting an offer in compromise.*
- IRS collection actions. It covers liens, releasing a lien, levies, releasing a levy, seizures and sales, and release of property.*

*Your collection appeal rights are explained in detail in Publication 1660, *Collection Appeal Rights*.*

Innocent Spouse Relief

Generally, both you and your spouse are responsible, jointly and individually, for paying the full amount of any tax, interest, or penalties due on your joint return. However, if you qualify for innocent spouse relief, you may not have to pay the

tax, interest, and penalties related to your spouse (or former spouse). For information on innocent spouse relief and two other ways to get relief, see Publication 971, Innocent Spouse Relief, and Form 8857, Request for Innocent Spouse Relief (And Separation of Liability and Equitable Relief).

REFUNDS

You may file a claim for refund if you think you paid too much tax. You must generally file the claim within 3 years from the date you filed your original return or 2 years from the date you paid the tax, whichever is later. The law generally provides for interest on your refund if it is not paid within 45 days of the date you filed your return or claim for refund. Publication 556, Examination of Returns, Appeal Rights, and Claims for Refund, has more information on refunds.

If you were due a refund but you did not file a return, you must file within 3 years from the date the return was originally due to get that refund.