IRS Audit Red Flags: The Dirty Dozen

Here are twelve hot spots on your return that can raise the chances of scrutiny by the IRS.

By Joy Taylor, Kiplinger Tax Letter, December 2010

Ever wonder why some tax returns are audited by the IRS while most are ignored? Well, there's a whole host of reasons to this age-old question. The IRS audits only about 1% of all individual tax returns annually. The agency doesn't have enough personnel and resources to examine each and every tax return filed during a year. So the odds are pretty low that your return will be picked for an audit. And of course, the only reason filers should worry about an audit is if they are cheating on their taxes. However, the chances of you being audited or otherwise hearing from the IRS can increase depending upon various factors, including whether you omitted income, the types of deductions or losses claimed, certain credits taken, foreign asset holdings and math errors, just to name a few. Although there's no sure way to avoid an IRS audit, you should be aware of red flags that could increase your chance of drawing some unwanted attention from the IRS. Here are the 12 most important ones:

1. Failure to report all taxable income.

The IRS receives copies of all 1099s and W-2s that you receive during a year, so make sure that you report all required income on your tax return. the IRS computers are pretty good at matching these forms received with the income shown on your return. A mismatch sends up a red flag and causes IRS computers to spit out a bill. If you receive a 1099 for income that isn't yours or the income listed is incorrect, get the issuer to file a corrected form with the IRS.

2. Returns claiming the home-buyer credit.

First-time homebuyers and longtime homeowners who claimed the homebuyer credit should be prepared for IRS scrutiny. Make sure you submit proper documentation when taking this credit. First-time homebuyers have to attach a copy of their settlement statement to the return, and longtime homeowners should also attach documents showing prior ownership of a home, including records of property tax and insurance coverage. All claims for this credit are being screened. As of May 2010, more than 260,000 returns had been selected for correspondence audits (examinations done by mail rather than face-to-face) because filers did not attach the necessary documents to their tax returns. And those numbers will continue to grow.

Also, the IRS has ways of policing the recapture of the homebuyer credit. Generally, the credit is required to be recaptured if the home is sold within three years for homes brought in 2009 or 2010 and within 15 years for homes bought before 2009. The IRS is checking public real estate databases for sales of homes for which the credit was taken.

3. Claiming large charitable deductions.

This comes up again and again because the IRS has found abuse on audit, especially with those taking larger deductions. We all know that charitable contributions are a great write-off and help you to feel all warm and fuzzy inside. However, if your charitable deductions are disproportionately large compared to your income, it raises a red flag. That's because the IRS can tell what the average charitable donation is for a person in your tax bracket. Also, if you don't get an appraisal for donations of valuable property or if you fail to file Form 8283 for donations over $500, the chances of audit increase. Be sure you keep all your supporting documents, including receipts for cash and property contributions made during the year, and abide by the documentation rules. And attach Form 8283 if required.

4. Home office deduction.

The IRS is always very interested in this deduction, primarily because it has a pretty high adjustment rate on audit. This is because history has shown that many people who claim a home office don't meet all the requirements for properly taking the deduction, and others may overstate the benefit. If you qualify, you can deduct a percentage of your rent, real estate taxes, utilities, phone bills, insurance, and other costs that are properly allocated to the home office. That's a great deal. However, in order to take this write-off, the space must be used exclusively and on a regular basis as your principal place of business. That makes it difficult to claim a guest bedroom or children's playroom as a home office, even if you also use the space to conduct your work. Exclusive use means a specific area of the home is used only for trade or business, not also where the family watches TV at night. Don't be afraid to take the home-office deduction if you're otherwise entitled to it. Risk of audit should not keep you from taking legitimate deductions. If you have it and can prove it, then use it.

5. Business meals, travel and entertainment.

Schedule C is a treasure trove of tax deductions for self-employeds. But it's also a gold mine for IRS agents, who know from past experience that self-employeds tend to claim excessive deductions. Most under-reporting of income and overstating of deductions are done by those who are self-employed. And the IRS looks at both higher-grossing sole proprietorships as well as smaller ones.

Big deductions for meals, travel and entertainment are always ripe for audit. A large write-off here will set off alarm bells, especially if the amount seems too large for the business. Agents know that many filers slip in personal meals here or fail to satisfy the strict substantiation rules for these expenses. To qualify for meals or entertainment deductions, you must keep detailed records generally documenting the following for each expense: amount, place, persons attending, business purpose and nature of discussion or meeting. Also, receipts are required for expenditures over $75 or any expense for lodging while traveling away from home. Without proper documentation, your deduction is toast.

6. Claiming 100% business use of vehicle

Another area that is ripe for IRS review is use of a business vehicle. When you depreciate a car, you have to list on Form 4562 what percentage of its use during the year was for business. Claiming 100% business use for an automobile on Schedule C is red meat for IRS agents. They know that it's extremely rare that an individual actually uses a vehicle 100% of the time for business, especially if no other vehicle is available for personal use. IRS agents are trained to focus on this issue and will closely scrutinize your records. Make sure you keep very detailed mileage logs and precise calendar entries for the purpose of every road trip. Sloppy recordkeeping makes it easy for the revenue agent to disallow your deduction. As a reminder, even if you use the IRS' standard mileage rate to deduct your business vehicle costs, ensure that you are not also claiming actual expenses for maintenance, insurance and other out-of-pocket costs. The IRS has found filer noncompliance in this area as well and will look for this.

7. Claiming a loss for a hobby activity.
Your chances of "winning" the audit lottery increase if you have wage income and file a Schedule C with large losses. And, if your Schedule C loss-generating activity sounds like a hobby…horse breeding, car racing, and such…the IRS pays even more attention. It's issued guidelines to its agents on how to sniff out those who improperly deduct hobby losses. Large Schedule C losses are audit bait, but reporting losses from activities in which it looks like you might be having a good time is just asking for IRS scrutiny. Tax laws don't allow you to deduct hobby losses on Schedule C; however, you do have to report any income earned from your hobbies. In order to claim a hobby loss, your activity must be entered into and conducted with the reasonable expectation of making a profit. If your activity generates profit three out of every five years (or two out of seven years for horse breeding), the law presumes you're in business to make a profit, unless the IRS establishes to the contrary. If audited, the IRS is going to make you prove you have a legitimate business and not a hobby. So, make sure you run your activity in a business-like manner and can provide supporting documents for all expenses.

8. Cash businesses.
Small business owners, especially those in cash-intensive businesses…taxi drivers, car washes, bars, hair salons, restaurants and the like…are an easy target for IRS auditors. The agency is well aware that those who primarily receive cash in their business are less likely to accurately report all of their taxable income. the IRS wants to narrow the tax gap, and history has shown that cash-based businesses are a good source of audit adjustments. It has a new guide for agents to use when auditing cash intensive businesses, telling how to interview owners and noting various indicators of unreported income.

9. Failure to report a foreign bank account.
The IRS is intensely interested in people with offshore accounts, especially those in tax havens. U.S. tax authorities have had some recent success in trying to get foreign banks (such as UBS in Switzerland) to disclose information on U.S. account holders. Also, the IRS had a voluntary compliance program where people came in and reported their foreign bank accounts and foreign assets in exchange for lesser penalties than they would have otherwise been subject to. The IRS has learned a lot from these probes. Failure to report a foreign bank account can lead to severe penalties, and the IRS has made this issue a top priority. Make sure that if you have any such accounts, you properly report them when you file your return. Keep in mind, though, that if you have never previously reported the foreign bank account on your return, and you decide to do so for the first time in 2010, that might also look suspicious to the IRS.

10. Engaging in currency transactions.
The IRS gets many reports of cash transactions in excess of $10,000 involving banks, casinos, car dealers and other businesses, plus suspicious activity reports from banks and disclosures of foreign accounts. A recent report by Treasury inspectors concluded that these currency transaction reports are a valuable source of audit leads for sniffing out unreported income. The IRS agrees and it will make greater use of these forms in its audit process. So if you are a person who makes large cash purchases or deposits, be prepared for IRS scrutiny. Also, beware that banks and other institutions file reports on suspicious activities that appear to avoid the currency transaction rules (such as persons depositing $9,500 cash one day and an additional $9,500 cash two days later).

11. Math errors.
One of the biggest reasons that people receive a letter from the IRS is because of mathematical mistakes they make on their tax returns. If you make an error in your favor, you are going to hear from the tax man, and there is a greater risk of the IRS pulling the whole return for audit. So take time to ensure all your calculations are correct. Even though math errors may not lead to a full-blown audit, it's always best to remain under the radar of IRS computers.

12. Taking higher-than-average deductions.
If deductions on your return are disproportionately large compared to your income, the IRS audit formulas take this into account when selecting returns for examination. Screeners then pull the most questionable returns for review. But if you've got the proper documentation for your deduction, don't be scared to claim it. There's no reason to ever pay the IRS more tax than you actually owe.

The quick list: The IRS's "Dirty Dozen"

1. Failure to report all taxable income
2. Returns claiming the home-buyer credit
3. Claiming large charitable deductions
4. Home office deduction
5. Business meals, travel and entertainment
6. Claiming 100% business use of vehicle
7. Claiming a loss for a hobby activity
8. Cash businesses
9. Failure to report a foreign bank account
10. Engaging in currency transactions
11. Math errors
12. Taking higher-than-average deductions