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IRS Audits 101

A guide to understanding IRS audits, how they're selected, and how to survive one

Table of Contents

Introduction

This guide will:

- Explain how IRS audits are selected
- Outline the usual process of an IRS audits, and the different ways they can conclude
- Give you tips and strategies on making IRS audits as smooth as possible

If you have any questions about what you've read in this e-book, or would like to discuss your business's bookkeeping needs, feel free to contact Code Accounting for a timely consultation

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Audits Can Be Scary - But They Don't Have to Be

An IRS audit is not something you want to have to think about. At best, most people think of an audit as a hassle. At worst they can be detrimental to you or your business's financial livelihood. But as is the case with most business related matters, being prepared is key to mitigating risk. This guide is intended to help you understand how audits work, what's at stake, and in the chance you are selected, what you can do to make the process as smooth as possible

Why are people afraid of IRS audits?

Many business owners will say that an IRS audit is hassle. The request for documents and verification can eat up a lot of time, and being unable to locate the documents required can be incredibly stressful.

An IRS audit can also result in a business paying more in taxes than they did for the year they filed, which can be cumbersome to individuals and business owners. Audits generally focus on taxes paid within the last year or two, but can go back farther. If a business paid $10,000 in 2014, but an audit several months down the line finds that they actually owed $15,000, that's a $5,00 cost that the business had not accounted for in 2015, and may have to come out of other investments and expenses.

Many individuals and business owners also feel unequipped to defend and advocate for themselves throughout an audit. As tax law becomes more and more complex, the average individual is often unaware of their rights and their true tax liability. IRS Auditors can often be very aggressive, and their findings can be incorrect—but some people, not being aware, end up forking over money that they didn't truly owe.

Finally, in rare cases, an audit may uncover a high level of negligence, which can result in jail time.

An Audit Can Cost You:

Time
tracking documents, meeting with your auditor, appealing your case

Stress
being distracted from your regular business management

Money
being ordered to pay more in taxes than you anticipated

What is an IRS Audit?

An IRS audit is an inspection of an individual or an organization's tax documents by the IRS to ensure the the information provided was accurate. The ultimate purpose of an IRS audit is to make sure that a tax-payer paid the right amount in taxes and is following Generally Accepted Accounting Practices (GAAP).

IRS Audit

A review/examination of an organization's or individual's accounts and financial information to ensure information is reported correctly according to the tax laws and to verify the reported amount of tax is correct.

In order to determine which businesses will be selected for an audit, the IRS uses a scoring system referred to as the Discriminant Inventory Function System (DIF) and the Unreported Income Discriminant Formula (UIDIF). The higher those number, the more likelihood that your tax liability is different than what was paid, and the higher the likelihood that a business will be selected by an audit.

Certain aspects of a tax return will raise the DIF score, like participation in a tax shelter, as well as large charitable contributions, home office deductions, large travel and entertainment expense or large automobile expense.

The purpose of a UDIF is to determine the probability of inaccurate information and the probability of omitted income on a tax return. A few things can increase the UDIF score. One is if a tax-payer is of high income. High income tax returns are generally more complicated, often resulting in more omissions. Another red flag for a UDIF number is a high number of deductions. These are more likely to be subject to IRS audits in order to ensure all of those deductions were appropriate and applicable. Self employed tax-payers are also often likely to be audited. As more and more individuals in the workforce are self-employed, it's more important than ever that organized tax records are a priority.

How do I know if I've been selected?

A business or individual may also be selected on basis of a related examination. For example, if the IRS is auditing a business, or a business is charged with fraud, the business' partners may also be selected for audit.

You will be notified of an audit through the email. **The IRS does not initiate the audit process through the phone.**

Reasons You Can Be Selected for an Audit

- You're a high income earner
- A high number of deductions on your return
- You're self-employed
- You worked with a business or individual that was also audited

What kind of documentation do they require?

The IRS often requests the following documents. If you have been working with a certified accountant who has been managing your financial records, these can be easy to obtain:

- Receipts
- Bills
- Canceled checks
- Legal papers
- Loan agreements
- Logs or diaries
- Tickets
- Medical and Dental records
- Medical savings account statements
- A copy of a handbook or other statements showing benefit and reimbursement policies
- Physician statements
- Capital improvement records
- Contract for attendant care
- Theft or loss documents
- Insurance reports detailing
- Brief explanation of the loss
- Employment documents
- Schedule K-1 – These are used to report each shareholder's share of income, losses, deductions and credits when an S corporation files its annual tax return.

What Happens at the End of an Audit?

No Change
The auditor determines, based on their findings, that you don't need to alter the amount you paid in taxes.

Agreed Upon Changes
The IRS determines there are changes that need to be paid, and you accept these conditions and plan to proceed with the altered exchange of taxes.

Disagreement over changes
You also have the option to contest the changes the IRS has instituted by requesting mediation or appealing to a court. If you choose to appeal a finding, it's important that your records are impeccably kept, so that you can present as much verifiable information in court or in mediation as possible.

Setting up a Payment Plan

If you do end up owing the IRS in taxes, despite attempts at mediation and taking the case to court, you must eventually pay those taxes. Failure to do so can result in the IRS taking a lien out on your home, freezing your bank accounts, seizing your refunds, or even garnishing your wages.

If you don't have the money you owe to the IRS available right away, you also have the option of setting up a payment plan to pay in installments. Both individuals and small businesses can take advantage of a payment plan option, if they fulfill certain requirements.

Payment Plan - Requirements & Steps

Inviduals

Owe $50,000 or less in income tax, interest, and penalties (combined):

- Fill out IRS Form 9465 (Installment Agreement Request).
- Apply through the IRS.gov website with the Online Payment Agreement Application.
- Call the phone number provided on the IRS
- etter to request a payment plan
  Call the IRS Individual Assistance line at 1-800-829-1040.

Owe more than $50,000 or more in income tax, interest, and penalties (combined):

- Fill out Form 9465 as well as Form 433-F

Small Businesses

Owe $25,000 or less

- Request an "In-Business Trust Fund Express" installment agreement (IBTF-Express IA)
- If the amount owed is greater than $10,000 (and below $25,000), the business must set up a Direct Debit installment agreement (DDIA).
- Call the phone number on your IRS notice or tax bill
- Call the IRS Business Assistance line at 1-800-829-4933.
- Apply through the IRS.gov website with the Online Payment Agreement Application.

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IRS Audits Don't Have to be Intimidating

An IRS audit doesn't need to be scary, especially if:

> You're not willfully committing fraud

> You've been maintaining careful records
> of your business transactions

> You've been following the regulations
> that govern your tax liability

> You know your rights

If you've been utilizing the help of a CPA with your bookkeeping, chances are, the required documents are available to you right away, reducing the amount of time you have to spend flipping through paperwork. A good CPA is also staying in the know about tax law and your rights and obligations as a taxpayer. Oftentimes, an IRS audit may conclude with a change that needs to be contested. Your tax professional can help you prepare with all of the necessary, verifiable information you need to advocate for you and move forward, and can even help negotiate on your behalf.

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Code Accounting understands that an audit can stray your focus and lag the growth of your company or your brand by demanding your time and sometimes your money.

If you're interested in ways you can make sure you're always prepared for an audit, that your tax preparation is done correctly, and that you are aware of your rights and obligations feel free to contact Code Accounting at (510) 706-2877.

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