IRS Tax Audits - 2016

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IRS Tax Audits (2016)

The IRS has shifted their focus to auditing higher income taxpayers. While less than one per cent of all individual tax returns are audited (.86% in 2014; .084% in 2015) higher income taxpayers have a greater audit risk:

Income Levels

1) Over $200k-$1m 4% (1 in 25);

2) $1m-$5m 12.5% (1in 8)

3) $5m-10m 16% (1 in 7)

4) Over $10m 24% (1 in 4)

Top IRS Audit "triggers" include:

1) Higher Income Levels

2) Underpayment of Taxes (prior years)

3) Large Losses Declared

4) Failure to Accurately Report Income Listed on Form 1099 or Form W-2

5) Taking Higher-than Average Deductions

6) Filing Schedule C for a Small Business - with special scrutiny given to cash-intensive businesses (e.g. hair salons, restaurants and bars)

7) Declaring Large Charitable Deductions

8) Claiming Rental Losses. The passive loss rules prevent the deduction of rental real estate losses with two important exceptions: active participation in property rental allows deduction of up to $25k against other income (the $25k allowance phases out as adjusted gross income exceeds $100k and disappears entirely once AGI reaches $150k)

A second exception is for real estate professionals who spend more than 50% of their working hours and over 750 hours each year materially participating in real estate as developers, brokers, & individuals; they can write off losses without limitation.

The IRS has a real estate professional audit project started several years ago. The IRS actively scrutinizes rental real estate losses especially those written off by taxpayers claiming to be real estate professionals. It reviews tax returns of individuals who claim to be real state professionals and who show other income eg. W-2 income (employees) and non-schedule C business income. IRS agents check whether the taxpayer worked the necessary hours, especially in cases of landlords whose day jobs are not in the real estate business.

9) Alimony: A trap for the unwary. Both the alimony payer and recipient must consistently report the alimony on tax returns, a reporting mismatch often triggers IRS audits.

The tax rules on alimony are complicated:

a) Alimony paid by cash or check is deductible by the payer and taxable to the recipient provided requirements are met.

b) Alimony payments must be made under a divorce or a separate maintenance agreement.

c) The agreement can not say the payment is not alimony.

d) The payer's liability for the payments must end when the former spouse dies.

10) Deducting of Hobby Losses. Taxpayers must report income from a hobby and can deduct expenses up to that level of income but the tax law bans writing off hobby losses. To be eligible to deduct a loss, you must be running the activity in a business-like manner and have a reasonable expectation of making a profit.

If the the activity generates profit 3 out of every 5 years (or 2 out of 7 years for horse breeding), the law presumes you are in business to make a profit, unless the IRS establishes otherwise (supporting documentation is required for all expenses deducted).

11) Deducting Business Meals, Travel and Entertainment. Large tax deductions for meals, travel and entertainment are ripe for audit whether deducted on Schedule C by business owners or Schedule A by employees. To qualify meal or entertainment deductions, taxpayer must keep detailed records that document for each expense the amount, the place, the people attending, the business purpose and the nature of the discussion of the meeting. Receipts are required for expenses over $75 or for any expense for lodging while traveling away from home.

12) Failure to Report a Foreign Bank Account. IRS is intensively scrutinizing funds stashed outside the US and is receiving information from amnesty seekers, and banks and foreign financial institutions for names of US owners of foreign accounts.

The Foreign Account Tax Compliance Act was enacted March 2010, but not effectively implemented until 2015 at which time foreign banks/institutions commenced disclosing the names of US taxpayers with accounts in their countries. As of 2016, over 100,000 foreign financial institutions in over 80 countries are disclosing US taxpayer undeclared foreign accounts. The epi-center of offshore tax evasion, whose banking system has been publicly described by the former Managing Director of Wegelin Bank (Switzerland's oldest bank since 1741, which shut down after pleading guilty to tax evasion) as "profiting from tax evasion". As of 2/16 95 Swiss Banks have signed settlements with the US Department of Justice, most recently Bank of Julius Baer (see IRS Off-shore Voluntary Disclosure Program Frequently Asked Questions 2014 (effective 7/1/14, updated 2/8/16) see FAQ # 7 for complete list of Swiss banks.

The IRS Offshore Voluntary Disclosure Program as of 8/4/14 , requires 50% penalty (of the account balance penalty) for all listed foreign financial institutions who have settled with the US Govt. (including 95 Swiss banks) or who are under investigation or received a John Doe summons (the IRS/Treasury Dept investigation has now spread to the Caribbean). The 50% penalty must be paid up front on submission of the OVDP application plus payment of income tax due on the earnings, a 20% accuracy-related tax (on underpayment of tax), and up to 25% penalty for failure to pay tax and/or file tax returns. In addition, all account statement for the foreign undeclared bank accounts must now be submitted with the OVDP application for prior 8 years.

13) Currency Transactions. IRS receives multiple reports of cash transactions in excess of $10,000 from banks, casinos, car dealers, and other businesses plus suspicious activity reports from banks and disclosures of foreign accounts. LARGE CASH PURCHASES ARE UNDER HEIGHTENED AUDIT SCRUTINY.

Banks and other institutions file reports on suspicious activities that appear to avoid currency transaction rules (e.g. a person depositing $9500 in cash one day and an additional $9500 in cash two days later).

14) Claiming 100% business use of a vehicle;

15) Taking an Early Pay-out form an IRA or a 401-K account;

16) Claiming Day-Trading Losses on Schedule C. To qualify as a trader, Taxpayer must buy and sell securities frequently and look to make my money on short-term swings in prices, and the trading activities must be continuous. This activity is different than an investor who profits mainly on long-term appreciation and dividends ie. investors hold their securities for longer periods and sell much less often than traders.

Securities traders have significant tax advantages (compared to other investors)

The expenses of traders are fully deductible and are reported on schedule C (investors report their expenses as miscellaneous itemized deductions on Schedule A, subject to an offset of 2% of adjusted gross income. Traders profits are exempt from self-employment tax. Losses of traders who make a special deduction IRC 475(f) are fully deductible and are treated as ordinary losses that aren't subject to the $3000 cap on capital losses.

17) Gambling: Failing to Report Winnings or Claiming Big Losses

18) Claiming Home Office Deduction.