Money Talks April 2023

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The Inflation Reduction Act of 2022 is providing the IRS with an influx of about $80 billion to modernize outdated technology and rebuild a depleted workforce, which is expected to improve enforcement to the tune of about $200 billion over a decade. Treasury Secretary Janet Yellen directed the agency not to use additional resources to increase audit rates for taxpayers making under $400,000 a year, but the tax returns of high-earning business owners are likely to face more scrutiny than they have in years past.

IRS audit rates for individual, partnership, and S corporation income tax returns have fallen since 2010, a trend that could reverse as the IRS ramps up enforcement. Higher audit rates won't appear overnight, but large investments to upgrade technology could eventually help the IRS develop more advanced enforcement methods. There may be steps you can take to avoid unwanted attention from the IRS.

Tax returns are randomly selected, which means you might be audited even if you do everything by the book. However, when your tax return is processed, a computer program screens for anomalies and compares deductions to those of taxpayers with similar incomes. Your return is more likely to be chosen if there's a higher chance that it would result in the collection of additional taxes, but an audit can also be triggered by a red flag on your return or a simple mistake that leads to additional questions. If selected for a correspondence audit, you may be asked to mail specific information to the IRS. A comprehensive field audit would be conducted at your home, place of business, or accountant's office.

Filing an incomplete tax return (with missing forms or schedules) and not making tax payments on time are surefire ways to attract unwanted attention from the IRS. Taking business deductions that are not in line with industry norms, not categorizing transactions consistently from year to year, having a high number of independent contractors relative to full-time employees, and reporting continuous losses are all situations that can look suspicious, even if they are valid.

Taxpayers are required to keep tax records for at least three years from the date the tax return was filed. Organizing and possibly digitizing your records could make it easier to respond to any requests for information that may come from the IRS, and not being able to provide a requested document could negatively impact your audit results. A heightened focus on compliance means it may be more important than ever to consult an experienced tax professional for personalized guidance, especially if you receive any type of communication from the IRS.

Each taxpayer should seek independent advice from a tax professional based on his or her individual circumstances. To the extent this material concerns tax matters, it is not intended or written to be used by a taxpayer for purposes of avoiding penalties that may be imposed by law.