

## CHAPTER 3 WHAT ARE THE RED FLAGS THAT WILL PROMPT AN IRS AUDIT?

Now is a good time for us to discuss red flags that will get you audited. Whether you have a small business or you have a job there are actions that you can take, or not take, that will prompt the IRS to pull your tax return for an audit. Unlike some of the IRS propaganda that says most tax returns are randomly selected, there are many that are selected because the business owner or wage earner waived a big red flag saying, “Come and get me!”

In this chapter I will give you these red flags and show you how to avoid them in the future. I will also tell you how to handle the IRS if your return has been selected because of one or more of these red flags. So just sit back and take notes on these secrets, straight from a former insider.

### **RED FLAG DEFINED**

First I want to make sure we are on the same page about the definition of “Red Flag.” The Webster Dictionary definition of red flag is: “A warning sign; a sign that there is a problem that should be noticed or dealt with”. The IRS uses a variety of methods to expose red flags in all types of tax returns. They do use statistical data and mathematical algorithms based on national norms. However, those are only a few methods used. In addition, there are red flags that aren’t even generated inside of the IRS but come from our everyday environments. Let’s review them so that you will know what they are and do your best to avoid falling into the IRS’s red flag trap.

### **ROUND NUMBERS**

When I was in revenue agent training one of the first things that I learned is that when I received a tax return for audit and the numbers on the return were all or mostly round numbers it was probably lots of estimates. People that don’t keep good books and records tend to estimate when preparing their tax returns. For example, if a couple has rental property that they were not keeping up with they may write down monthly income of \$600, which would be \$7,200 per year.

Although they charged \$600 per month, if they estimated based on their normal monthly rental then they did not include late charges or any other charges that the renters had to pay. In addition, if the rental expenses were round numbers they probably guessed at the actual amount of utilities paid, rental maintenance and even commissions paid to property management companies.

The advice about round numbers usually turned out to be true and over 95% of the time that I audited a tax return with round numbers there were large adjustments to the refund claimed or amount owed based on the original return.

## **HAVING A HOME-BASED BUSINESS**

First let me say that I believe everyone should have a home-based business because the benefits far outweigh the risks. With that said, one of the main reasons that having a home-based business is an audit red flag is because these Schedule C or small corporate tax returns are used to train new revenue agents. When the IRS trains new agents they don't want to give them tax returns containing only W-2 wages that had the taxes taken out and on which the person is receiving a refund. Aside from that being a complete waste of time it would get a new revenue agent in the habit of performing lots of "no-change" audits, and the IRS surely doesn't want that. Instead, they let new revenue agents cut their teeth on home-based business tax returns because they feel there is a better chance that the business owner either left off some of the income earned or padded the expenses. When I was a revenue agent many times the expenses were overstated and sometimes the income was understated.

## **HOME OFFICE DEDUCTION**

Another reason that home-based businesses are a red flag for audit is that business owners will write off too much of their home space and home expenses on their business returns. The IRS says that the space used for business must be used exclusively and regularly for business. For example, if the business was done in a small bedroom the business owner was supposed to measure that room and use the square footage of that room versus the square footage of the entire house. Many

times people would deduct half the utilities, mortgage and real estate taxes, which would result in a large audit adjustment against them. Also, if all business was done at the kitchen table no deductions were allowed. In the initial interview, which we will discuss later, the revenue agent would ask where the business was conducted, and if the business owner said the kitchen, living room or other shared room they lost that entire deduction.

## **HIGH CHARITABLE CONTRIBUTIONS**

Based on statistical data, the IRS has determined that most people that go to church give about \$26 a year (\$1 per Sunday) and give less than \$100 a year to other charitable organizations. With that in mind, people that are big givers tend to be flagged for audit. Christians and those in other religions that give tithes and offerings are highly susceptible to audits because their giving stands out like a sore thumb. If a Christian earns \$75,000 a year it looks highly unusual for cash contributions to be \$8,000 and that return is likely to be selected for an audit. It would usually not be an extensive audit but could turn into one if the person couldn't substantiate the amount deducted.

As far as non-cash charitable contributions are concerned, when a person has deducted a high amount in that category, another red flag is raised. If the person did not keep the proper records to prove the deduction then an audit adjustment is likely. So make sure you follow proper record keeping procedures for non-cash deductions given to the Salvation Army, churches, Goodwill or similar organizations. I explain the beauty of taking non-cash charitable contributions deductions in Chapter 14 of this book.

## **CONSISTANT BUSINESS LOSSES**

When you have a home-based business or even a brick and mortar business, and you claim losses for three years in a row, the IRS can consider your business a hobby and try to disallow your losses. Good books and records are the key to proving that you are not running a hobby. Most businesses have losses for the first few years due to the start-up process, but make sure that after the first few years

you keep a proper accounting of your business so that you can stand up to the IRS if they insult your hard work by calling your business a hobby.

## **NOSY/JEALOUS NEIGHBORS**

No this one you won't find in popular newspapers and magazines come January. I experienced many audits that were prompted by nosy or jealous neighbors. The nosy neighbor that sees you driving up in a brand new car, your children in private school and your frequent vacations may feel as though you are not reporting everything you earn. This is especially if you live in a middle class neighborhood. For example, If David Do-Right and his family purchased a house that was well below what they can afford, they can use additional funds on cars, private school and travel. A nosy neighbor that assumes that David bought the house for a price that reached his allowable borrowing limit may think that the Do-Rights are doing something illegal or hiding income. These nosy people will actually call the IRS hotline! Thousands of people call the IRS hotline every year to tell on other people. Some of these snitches even try to earn cash awards for their information, just like in some scary futuristic movie where everyone is spying on everyone else.

An actual situation that I am aware of involved an African-American couple that moved into an upscale neighborhood on the ritzy side of town. The husband earns six figures and the wife is self-employed and home schools their children. This couple was selected for audit, and when the husband asked why they were selected the insinuation was that somebody didn't like the idea of him moving his family into that exclusive neighborhood.

Whether the issue is racial, economic or just jealousy; everyone has to be aware that your neighbors can red flag you for an audit.

## **AN UNSCRUPULOUS TAX PREPARER**

The IRS has recently tightened up on whom, besides the “taxpayer” is allowed to prepare tax returns. Shade tree tax preparers and even preparers sanctioned by the IRS don’t always follow the IRS protocol. The biggest problem that I have seen with tax preparers that aren’t CPA’s is that they tend to overstate expenses on their client’s tax returns to either garner larger refunds or wipe out any amount owed. I have seen many cases involving tax preparers that had people lined up outside their doors during tax season because they gained the reputation of getting people big tax refunds. Often when these same tax returns are audited and the IRS realized that the returns were prepared by the same person, the IRS will go in and seize all of the preparer’s records and audit each and every one of their clients because they are pretty sure all the returns have overstated expenses. Some of these tax preparers end up in prison for fraud. In one case the people were paying the preparer based on the amount of refund she could get them. For example, if she prepared a return and the refund was \$5,000 she received \$500, not a standard preparation fee schedule, like most tax preparers maintained. When the IRS recognized what she was doing they seized all of her client records and prosecuted her for fraud. Each and every one of those clients pointed their fingers right at her and she went to prison. People need to be very careful who they select to prepare their tax returns.

## **OMITTING 1099 INCOME**

Many self-employed people receive 1099 (Non-Employee Compensation) forms at the end of the year. Construction workers, independent computer programmers, graphic artists and musicians typically receive these forms. When one receives a 1099 it usually means that no taxes were deducted from the amount earned during the year. Thus, the IRS expects these people to send in a check every quarter to prepare for the amount due at yearend.

Some independent contractors have several different jobs or projects each year. If they don’t keep up with their pay on these contracts disaster may strike. When an independent contractor is paid over \$600 in any given year, the company or individual that paid them is supposed to send the IRS a copy of that 1099 by February of the next year. The IRS compiles records of each person’s 1099

earnings each year so that they can determine if that person reports all of those project earnings on their tax return.

If an independent contractor does not keep good accounting of his business dealings and leaves off or forgets a few projects, a red flag will wave. For example, if a musician plays the drums for several different churches in a year but he leaves off the income from two or three that paid him during the beginning of the year, he could be in hot water. If those churches sent the IRS 1099's stating that they paid him, his tax return will have a lower income than the IRS records and he will be hauled in for audit.

## **HIGH MILEAGE DEDUCTIONS**

Many people that have businesses have to drive all over town to conduct business. Many attempt to deduct mileage in excess of what the IRS allows. Commuting miles are considered miles from your home base to your first stop and from your last stop to your home base. If your first and last stops are your client's office the IRS considers that entire trip commuting miles. Because most home-based business owners don't know that, they end up with all of their so-called business miles disallowed.

Also, if your mileage deduction is very high in comparison to the money you made during the year you will raise a red flag. The IRS expects businesses to have expenses if they have income, but business owners that don't make much money yet take large mileage deductions look suspicious to the IRS.

Making sure that you document commuting miles and that you make a short business stop (like the local post office) before you make a long trip out to a clients office, Making sure that you record your mileage, will keep you away from raising that red flag.

## **CASH BUSINESSES**

The IRS realizes that there are many businesses that usually operate almost entirely in cash. These businesses include:

- Laundry Mats
- Dry Cleaners
- Convenience Stores
- Auto Repair Shops
- Weekly-stay Motels
- Beauticians and Barbershops

People that own these and similar cash businesses are always scrutinized by the IRS because many make a habit of not reporting all of the cash they collect. The IRS has been so concerned with these businesses that they have come up with special audit techniques to try and catch these business owners underreporting their income. For example, the special program to audit laundry mats involves obtaining all of the water bills for the year, counting the number of washing machines and their water capacity, finding out how much is charged for each load and estimating how much the business made that year.

The program set up for beauticians involves collecting the shampoo and relaxer/perm receipts, calculating how many washes/relaxers are done per container and how much was charged per service to determine whether the beautician left off income during the year. In each of these scenarios it is assumed by the IRS that the business owner deducted every expense that was available, so the assumption is that the receipts reflect the true amount used in the business.

Cash business owners should be aware of the special audit programs that have been developed for them and make sure they proceed accordingly.

## **HIGH TRAVEL AND ENTERTAINMENT EXPENSES**

Business owners with high travel and entertainment expenses persistently raise red flags for audit. It is the IRS's contention that travel and entertainment expenses are not always ordinary and necessary. They think that people take unnecessary trips that are really vacations, and list them as business trips. They think that when people go out to eat with clients it's really not about business.

A substantial write-off in this category will wave multiple red flags, especially if the amount deducted appears to be too high for the type of business the taxpayer

runs. When I was an IRS agent they had us looking for personal meals and other travel related claims that didn't satisfy the strict evidence rules.

In order to legitimately take the deduction for meals and entertainment, the business owner has to retain detailed records showing the amount of the expense, the place of the meeting or meal, the business associates in attendance, the business purpose and notes about what was discussed. In addition receipts must be kept for every expense in this category that is over \$75.

When you travel a lot for your business it would be a good idea to keep a separate folder for every trip, put the brochure and agenda for that event in the folder along with your hotel, airfare or rental car, meal, tip and taxi receipts. When you travel for business you deserve to get a deduction but make sure you keep your receipts and the documentation for the purpose of the trip so that you won't be slammed with a higher tax bill due to lack of books and records.

## **OFF SHORE BANKING**

The IRS is extremely interested in people with money in off-shore accounts; particularly if the money is in accounts in countries they consider tax havens. They've been on a mission to repatriate money that they think has been illegally taken or transferred into overseas accounts, and lately the IRS and other international tax authorities have been successful in getting foreign banks to divulge people's personal account information. That being the case, even if you have money in a perfectly legal account offshore, you could possibly be waving a red flag at the IRS.

Failure to report a foreign bank account can command harsh penalties. For example, failing to divulge assets exceeding \$10,000 that are being held in foreign bank accounts could make you liable for penalties and fines in the hundreds of thousands of dollars.

So, in order to eliminate any red flags for foreign finances, be sure to accurately report any foreign accounts. Reporting requirements are beyond the scope of this book, but if you have foreign accounts ask a competent accountant or lawyer for help.



## **YOUR HIGH PROFILE PROFESSION**

When I was an IRS agent a person was a walking red flag if he or she was a politician or a preacher. Ambitious IRS agents would like to get the chance to audit politicians and preachers because if there were major adjustments or scandals that were found during the audit the information may make it to the news, either locally or nationally. How many times have you seen politicians or preachers in the news for having tangled with the IRS? These agents would be rewarded with promotions and even cash for bringing down someone powerful, and they would salivate at the chance to take a well-known person down.

This ends our discussion of red flags. I hope that this chapter will help you avoid becoming a red flag in the eyes of the Insidious Representatives of Satan!