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ACCOUNTING

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4 WAYS TO GET AUDITED

Red flags that could cause your tax return to be targeted

By BERNADETTE STARZEE

Tax day is in the rearview mirror but there are roadblocks ahead for those individuals and businesses who will be chosen for an audit.

The chance of a federal audit is small – just about 0.6 percent of individuals are audited by the IRS. Fewer than one in 200 individuals earning between $25,000 and $200,000 are audited, according to IRS statistics. Those earning $10 million or more have the highest risk – a 14.5 percent chance – of hearing from the IRS.

Individuals and companies also may be subject to an audit from New York State, "which is very aggressive, particularly in the area of sales tax," according to Laurie Kazenoff, a partner at Moritt Hock & Hamroff in Garden City who co-chairs the tax department and concentrates her practice in tax controversy work.

While many audits are random, others are triggered by certain red flags. Here is a look at some of the most common ones.

Photo courtesy of Moritt Hock & Hamroff.

LAURIE KAZENOFF: Schedule C – a form filed by the self-employed – is the most commonly audited area.

Photo courtesy of Tenenbaum Law

KAREN TENENBAUM: Consecutive years of business losses will make examiners question if it's really a business or just a hobby.

Photo courtesy of Tenenbaum Law

LEO GABOVICH: New York State targets certain categories of businesses for sales tax audits, including hardware stores, auto body shops and restaurants.

Disproportionate numbers, especially on Schedule C

Many red flags show up on Schedule C, a form that is filed by sole proprietors.

"Schedule C is the most commonly audited area," said Kazenoff, who formerly was a senior attorney with the IRS's chief counsel's office. "There are many opportunities for taxpayers to perhaps fudge these numbers, which include underreporting income and overstating deductions such as home office deductions and other office-related expenses."

Most fields on a return are automated, and the numbers reported by the taxpayer are compared to averages. If the numbers reported are outliers, they're going to be flagged.

"If your home office expenses, travel expenses or telephone expenses are higher than for similar businesses, they will stand out," Kazenoff said. "For instance, a business owner with telephone expenses of $250 might be inclined to say, 'Let me make that $500.' But if it's higher than average, it may lead to an audit. It's important to only report expenses that you can substantiate."

Doctors, many of whom file Schedule C and have significant incomes, are often chosen for audits, according to Marisa Friedrich, an attorney at Tenenbaum Law, a Melville law firm that concentrates in tax controversy matters.

"A doctor may use his car to travel to several offices and nursing homes to see patients," she said. "It's difficult for busy professionals to keep track of the mileage, and often it falls by the wayside, and they estimate. They might report that the car is used mostly for business when in fact it's mostly for personal use."

Charitable deductions are another place where numbers are often flubbed.

"If you have a lot of charitable deductions, and you don't have that much income, the IRS is going to wonder if that's a real figure," Kazenoff said. "The number may be legitimate – you may be a very charitable person." But if it's an outlier, it may get you on the radar.

Big losses

Large losses on both individual and business returns will also be flagged, Kazenoff said.

"This is particularly true if they offset most or all of the income, begging the question, 'How is this individual supporting themselves?'" she said. "How is this business a going concern if it is showing such tremendous losses?"

Consecutive years of business losses will make examiners question if it's really a business, or just a hobby, said Karen Tenenbaum, attorney and founder of Tenenbaum Law. "For instance, if you own a racehorse, and you keep

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taking deductions and not earning a profit, it may be ruled a hobby," she said.

Missing information

Individuals who receive income from several sources commonly fail to report some of it.

"If you're an independent contractor or you have several jobs and you receive multiple 1099s or W-2s, you may forget about one of them," Kazenoff said.

Similarly, "if you have income from different investments, you might receive one form from Morgan Stanley, one from another investment firm, and you may miss one of them," Tenenbaum said. "If you go to the same accountant each year, your accountant might notice it's missing and catch the mistake."

But if not, the IRS will.

"Many people are actually unaware of 'third party reporting,'" Kazenoff said, noting that when taxpayers receive 1099 and W-2 forms, "the issuer is required to copy the IRS on those same forms. That means the IRS will know what you should be reporting.

"And if you fail to report those figures (to the penny) on the individual or business return, you will most definitely receive a letter from the IRS," Kazenoff said. "They have a matching system in place, and if your numbers don't match theirs as received by third parties, you will definitely be flagged."

This doesn't mean you will get audited, she added.

"You may just get a letter informing you that this is the tax that's due," she said. "But it may trigger an audit, especially if a substantial amount of income was not included." The thinking is, if you failed to include that, what else did you leave out?

Target industries

Cash businesses receive considerable scrutiny, and the IRS often targets particular types of industries where companies have historically underreported income, Kazenoff said. These include restaurants, laundromats, dry cleaners and gas stations.

"These types of businesses aren't just targeted for underreported income, but also for failures to pay proper sales taxes," she said.

Hardware stores, auto body shops and restaurants are among that categories of businesses targeted for sales tax audits in New York State, according to Leo Gabovich, an attorney at Tenenbaum Law.

"The state may choose to audit more companies in industries where they see a lot of people in that industry taking advantage of certain deductions in which there is a loophole or a perceived loophole," he said.

The state requires automobile insurance companies, franchisors and alcoholic beverage distributors to provide detailed information, which can be matched to what is reported by companies that do business with them.

"Auto insurance companies send out checks to collision shops for repairs; the state collects a list of these vendors," he said. "Franchisors must provide information on franchisee sales, and beverage distributors must report the amount of beverage sold to bars, etc."

Armed with this information, "the state can go to XYZ Auto Collision, which might say it only made $250,000 in income, but the insurance company information shows it was $500,000," Gabovich said.

> **CASH BUSINESSES RECEIVE CONSIDERABLE SCRUTINY, AND THE IRS OFTEN TARGETS INDUSTRIES WHERE COMPANIES HAVE HISTORICALLY UNDERREPORTED INCOME.**

Companies that have a higher percentage of tax exempt sales compared to other companies in their industry will generate interest, as well.

"Certain things are not taxable, such as warranty repairs," Gabovich said, noting that an auto repair shop may try to inflate its warranty repair numbers to pay less in sales tax.

Auditors may come to observe a business, such as a restaurant, to help with their analysis.

"They may look to see how many people come in for Sunday brunch," Kazenoff said. "Then they might look at the different bank accounts you have and the deposits you make. If you're going on fancy trips and you have a Lamborghini in your driveway, but you say you're only making $50,000 a year, they're going to wonder how you're affording all these things."

What to do if you're audited

The more complex the return and the bigger the numbers are the more important it is to get professional representation, Kazenoff said.

"You don't know how deep into the weeds they're going to get and the potential liabilities and penalties that could come out of it," she said. "Get someone who is aware of the system and knows what your rights are."

An audit notice is not necessarily a cause for panic.

"A lot of audits are random," Kazenoff said. "As long as you can substantiate what's on your tax return, it will be fine."

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