

The Active Audit

written by JARGAL OYUNBILEG

Tips and tricks to get through an audit as quickly and easily as possible.

In February, I attended the member meeting of the San Francisco Apartment Association in one of the historic buildings at Fort Mason. The presenters were from the Treasurer and Tax Collector's Office of the City and County of San Francisco. The presentation was about the gross receipts and payroll tax expense reporting for lessors of residential real estate. The presenter from the city connected to the treasurer's website, and showed us, step by step, how lessors of residential real estate can file the gross receipts tax forms online.

What caught my attention during the presentation was how the city uses the answers to the questions on the Gross Receipts and Payroll Tax Expense Form. There are questions on the tax form that help the city identify if the filer is compliant with the city's other tax filing requirements. For example, there is a question on the form asking if the filer has personal properties that are used for business. If the answer is yes, then I presume that a person (or a program) will be checking if the filer also filed the mandatory 571L Business Property Statement.

I am glad this cross checking of the forms and data came up during the presentation because I was planning to write some tips and recommendations on preparing for an IRS audit and what the best practices are, based on what we observe at our office. More and more agencies now require taxpayers to file their returns electronically. This

electronic filing simplifies processing, and the analysis of returns and data matching has become automated. Cross checking of tax compliance requirements has become manageable.

Sometimes, clients and prospective clients ask us if we can tell them why their returns were selected for an audit. We have asked IRS agents the same question, but we have never received clear and concrete answers. Is it possible that the initial selection of your federal income tax return for an audit is being done by a computer?

What we know for sure is that the tax returns are initially analyzed by computer programs based on set variables or a scoring system called the "DIF score." The returns that do not fit within the acceptable range of variables or scores are selected for further review. If your return is selected for an audit, here are some helpful tips and recommendations to get through the process as easily as possible.

Read the Notice

It is best to read the Notice and the Information Document Request letter carefully. Is it a correspondence audit where you need to mail documents supporting the specifically selected deductions? If yes, by when do you need to mail them?

Is it a field audit where the agent comes to your place of business? Is it an office audit where you need to go to the IRS office with your records? Which office of the IRS is sending this notice? Is there a

deadline that you need to communicate by and schedule an appointment?

In general, what information do you need to gather?

Review Your Returns

You need to review the tax return that was selected for an audit thoroughly. A best practice is to review your tax returns with critical thinking before you submit to taxing authorities. A question to ask yourself is, "Do the numbers make sense?"

Taxpayers need to be especially careful when using tax preparation software. We have seen a tax return where a taxpayer diligently answered questions about a certain deduction and diligently entered the same deduction amount each time the taxpayer was asked in different areas. The taxpayer thought he was following instructions, but ended up deducting the expense more than once on different schedules. (Most likely, what was paid once cannot be deducted twice.)

Can you figure out what the issues that led to the audit might be? At this point, if you are unsure about what the notice means and what your tax return really says, we strongly recommend that you consider having a professional represent you. Do not delay if you want to take this route.

Straightforward and simple returns are rarely selected for an office or field audit. Therefore, evaluate your situation and consider engaging with a tax professional to guide and represent you.

For example, if you failed to report any foreign financial assets or bank

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accounts, it is always best to be represented by a tax attorney and/or experienced tax professional. The tax consequences for failure to report can be significant.

Once engaged, a tax professional will communicate with the IRS on your behalf, schedule an appointment and meet with the auditor with or without your presence. The tax professional will also check your books and records—not only to prepare for the audit, but also to identify if there are any missed or overlooked deductions. Instead of a no-change result, you might walk out with a refund.

Gather Your Relevant Tax Documents

As soon as you receive an audit notice, make sure to read what items need to be verified. Make a list of items that you need to gather so that you can cross them off as you find them.

Locate your bank and the credit card statements. It sometimes takes weeks to receive missing bank statements after the request is made (if not already available online). Therefore, it's important to identify what you have and what you do not have early in the process. A best practice is to always download and save every statement as it becomes available to you. It is also best to use the "Check Copy" feature. Have you requested check images from the bank? Then you know that the cost of requesting numerous check images can be pricey.

To verify expenses, we recommend that you print out the expense detail report from your accounting software as the summary sheet, and organize supporting documents behind the summary for easy referencing. Neatly organized documents will simplify the process.

If any or all of the deductions include automobile, home office, meals and entertainment, be prepared to bring your mileage logs, appointment books, and/or calendars. For more about the record-keeping requirements for these three expenses, please refer to my article from the January 2014

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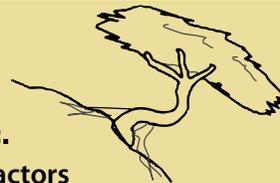
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issue of this magazine, "Recordkeeping Resolutions."

Reconcile Your Deposits

As mentioned above, the IRS agent will need to confirm that there is no unreported income. If you use a proprietary accounting software, such as QuickBooks, it is easy to identify non-income deposits to your bank accounts. If you do not use any software, it is best to come to the audit with gross deposit reconciliations. You will be asked to explain the difference between total deposits and total income reported on your return.

If you used one bank account for both business and personal purposes (not recommended), you can simply use an Excel spreadsheet and add all the deposits and credits from the monthly statements. From that sum, keep subtracting gross income that was reported on your tax return.

For example, from the total deposit amount subtract salaries (Form 1040); taxable and tax exempt interest and dividend (unless reinvested) income (Schedule B); business gross receipts (Schedule C); gross proceeds from the sale of investment stocks (Schedule D); gross rental income (Schedule E) and any other income that was reported on your tax return. Remember that you are comparing gross amounts to gross amounts.

If there is a significant difference remaining, you should identify the non-income deposits, such as refunds of purchases for personal use, transfers from savings accounts, cash from borrowings, draws from business and gift receipts, etc. These are your explanations of the differences between the income reported on your return and deposits reported on your bank statements. The goal is to come to a difference of an insignificant amount.

If you cannot locate your tax forms, or cannot locate your tax returns, you can always request your tax transcripts from the IRS. Even if you have the information, it does not hurt to know what information the auditors have and match the data to numbers you reported on your tax return. If the

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third-party information is incorrect, then you know you have an item to explain. It is better to be prepared than not.

You can call the IRS and make a request for a transcript or visit the IRS's website and use the tool called "Get Transcript." This tool is only available to individual taxpayers. The earliest transcript available is the return information timely filed three years back.

When Meeting with the Auditor

The initial examination/interview appointment is important. Ideally, you want to go in and come out with a no-change conclusion. Come prepared with organized documents and be able to explain any discrepancies.

If additional information is needed, schedule another appointment to bring the rest of the documents. Confirm repeatedly that that is the only pending item before reaching a conclusion. If no additional information is pending, ask how the auditor feels about the audit, what the auditor's preliminary conclusion is and when you can expect to hear back.

These days, the taxing authorities mandate that taxpayers file their returns electronically. As a result, the process of data analysis and data matching becomes an important and efficient tool for isolating returns that do not fit the preset range of acceptable returns. One of the ways taxpayers can walk one step ahead is getting transcripts online and comparing the transcript data to their data.

We all have those little portable hard drives, which can store so much data. Let's use them to store digital copies of tax returns; scanned receipts; past business diaries, calendars, logs and appointment books for easy access; and reproduction of documents in times of need. If you get audited, you'll be glad to have it.

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