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Balance sheet

IRS Audit Triggers

By Angela Bursby, CPA

An IRS audit is the last thing that anyone wants. Not only is an audit time consuming and stressful, but it can also be expensive. While always a constant threat, IRS audits are rare and only .4% of all individual tax returns were audited in 2019, most of which were conducted by mail with is less invasive than an in-person audit. Although being selected for an audit is rare, there are some 'triggers' that may increase your risk of being chosen.

First and foremost, be sure to report all taxable income. The IRS receives copies of all the W-2's and 1099's issued to you so make sure you include those as income. The IRS computers will automatically match their records with the income reported on your return and flag for differences. Another trigger is being in a higher income bracket. Your chances for audit go up to 1% on returns with income between $200,000 and $1M and to 2.4% for returns showing income of more than $1M. Also, taking higher-than-average deductions or credits can become a trigger if they are substantially higher than others in the same industry with the same income level. However, if you have support for those deductions, do not be afraid to claim them. Not all audits result in tax due. Large charitable donations can cause a return to be reviewed if they are disproportionately large compared to your income.

Filing a Schedule C can be a red flag also for those showing at least $100,000 in gross receipts and for cash-based businesses such as hair salons, bars, restaurants, etc. Also, Schedule C filers who show substantial losses offsetting other income such as wages can trigger the IRS to look closer. Keep in mind that the IRS may be more apt to look at a return if a business does not show a profit for three out of every five years because they may consider it to be a hobby rather than a business being operated for profit. Another possible trigger is for those claiming rental losses on Schedule E. The passive loss rules do not allow the deduction of rental real estate losses unless you actively participate in the rental of the property or are a real estate professional. Even with these exceptions, there are some limitations that apply based on income level. Some other things for Schedule C and E filers to keep in mind are big deductions for meals and travel, automobile expenses, claiming 100% business use of a vehicle, and home office deductions. The following are some other specific situations that may cause a red flag for the IRS, including claiming the American Opportunity Tax Credit for college expenses for more than four years, incorrectly reporting the health premium tax credit for Marketplace health insurance, taking an early payout from a retirement account that should be subject to the 10% penalty, failure to report gambling winnings or claiming big gambling losses, engaging in virtual currency transactions (such as bitcoin), engaging in large cash transaction in excess of $10,000 involving banks, casinos, car dealers, pawn shops, etc., and failing to report foreign bank accounts on FinCEN 114 (FBAR) that total more than $10,000 at any point during the previous year.

While any of the above-mentioned scenarios can increase the risk of a closer look by the IRS, as long as you retain documentation to substantiate your expenses, there should be no issue even if there is an audit. Please contact our office if you have questions regarding items that may relate to your situation.