Avoiding Tax Audits, the Right Way

Beware of the many red flags that can trigger an audit.

BY MARK E. BATTERSBY

While the IRS's own figures reveal that, in general, only one or two percent of all taxpayers actually have their returns audited each year, the threat of an audit continues to strike fear into every podiatric professional. And that fear increased dramatically with the IRS's reported plans to hire an additional 87,000 workers.

In reality, what was once a large and inefficient federal bureaucracy, the IRS is changing to become more streamlined and, most importantly, catching more tax offenders. Today, the IRS enforces the tax law in a number of ways, including the increasingly more common correspondence (examination by mail) audits and the dreaded field (face-to-face audit) examinations.

Agents in back offices are being replaced by computers with complex algorithms that cast a wide net, one that pulls many law-abiding people into the chaos of an audit. The result is that many podiatry practices are being scrutinized far more often than the numbers indicate.

The IRS takes a dim view of a failure to report income than a minor overstatement of deductions. But keep in mind that there are penalties and then there is the fraud penalty, equal to a whopping 75% of the unreported tax. Fortunately, there are perfectly legal strategies that can greatly reduce that audit threat.

Triggering Mistakes and Round Numbers

The IRS obviously checks the math on every return and too many errors will trigger red flags. Incorrect totals for expenses, missing Form 1099s and transposed numbers are all believed to concern the IRS—even if the mistakes are not big.

The type of practice can affect deductions, especially those related to employment versus to owning and operating a practice. Although employment is considered a business, an employee's business expenses are largely relegated to being itemized deductions which aren't currently available. The Tax Cuts and Jobs Act of 2017 largely eliminated employee expense deductions until 2026.

The IRS is also reportedly on the lookout for numbers that are too round. After all, it is unlikely that all of the numbers shown on any return will end in fives and tens or even thousands.

Hints from the IRS

The IRS, itself, offers a few steps that every podiatric professional can take to reduce the risk of their podiatry practice becoming an audit target. For example:

- Don't report a loss. Never report a net annual loss for any practice or business
- Be specific about expenses
- Provide more detail when needed
- Be on time
- Avoid amending returns
- Match up all your paperwork
- Don't use the same numbers repeatedly
- Don't take excessive deductions.

Continued on page 124

While the IRS's own figures reveal that, in general, only one or two percent of all taxpayers actually have their returns audited each year, the threat of an audit continues to strike fear into every podiatric professional.

Tax Audits (from page 123)

Obviously, this list favors the IRS and the basic tax law. But keep in mind that no less a body than the U.S. Supreme Court has ruled that striving for the lowest possible tax bill is perfectly legal. Thus, reducing the possibility of an audit by not reporting a loss should be taken with a grain of salt.

Beyond the Obvious

Although not as common as they once were, tax shelters exist and participation is almost certain to attract attention. It is a similar story with large changes in income.

While many unexpected and significant swings in income can usually be easily explained, large inconsistencies in income from year to year are often an area of concern to the IRS. Changes in the amount of income reported is considered a main indicator of under-reported income.

Large shifts in income can be indicative of someone hiding income in either the current or in a past tax year. When taking a closer look at the income earned in different tax years (as well as substantiating documents), the IRS often finds discrepancies between what a podiatrist earned and what was reported.

Despite the recently partially postponed requirement that third-party payors report payments to recipients, cash remains a major red flag because it creates all sorts of problems for the IRS. It is almost impossible to track cash transactions, cash can be easily hidden, it is difficult for the IRS to verify and, despite the new reporting requirements, there are few electronic records to keep track of it.

Cash transactions go unreported by many who believe that cash doesn't have to be reported or, more common, those who figure the IRS will never know that cash was received. However, today's IRS targets returns where taxpayers or their practices or businesses may deal in large amounts of cash and consider it an audit red flag when a return contains a high probability of unreported income.

However, today's IRS targets returns where taxpayers or their practices or businesses may deal in large amounts of cash and consider it an audit red flag when a return contains a high probability of unreported income.

Independent Contractors. A disproportionate number of independent contractors as opposed to employees is more of an audit target today with the states also on the lookout for large numbers of independent contractors used by a business or practice.

A podiatric practice usually uses independent contractors to avoid paying payroll taxes—federal and state—including the employer portion of Social Security and Medicare demanded by the Feds. This doesn't mean the practice shouldn't use independent contractors, just ensure compliance with the IRS's worker classifications and the "worker status tests" that vary greatly from state to state.

Low Salaries for S-Corp Shareholders. Many podiatric practice principals set up an S-Corp instead of an LLC to avoid the 15.3% self-employment tax. However, while they aren't subject to self-employment tax on distributions, S-Corp shareholders working as employees must receive "reasonable compensation."

The IRS is on the lookout for S-Corps paying shareholder-employees unreasonably low (or even no) salaries. The IRS will compare compensation to the standard for a similar position in a similar industry.

Failure to provide shareholder/owners with reasonable compensation (as W-2 reportable wages) is an audit flag often leading to a more comprehensive audit of the entire podiatric practice.

Uncharitable Contributions. Inflated charitable contributions are among the most abused tax deductions and one of the biggest red flags on a tax return, personal, professional or business, deserving of an audit. The IRS will often challenge non-cash charitable contributions because there is at least some potential for change and additional revenue for the IRS.

Simply remembering to include the required schedule for non-cash contributions to charities goes a long way to reassuring the IRS that the contributions meet the proper substantiation requirements.

The Home Office. Even before the pandemic, the home office provided a place for podiatric professionals to catch up on paperwork, bookkeeping, or payrolls. With many taxpayers shifting to "work from home" during the Pandemic, it should come as no surprise that the home office deduction will continue to be under extra scrutiny.

The deduction for home offices is more complex than many professionals realize. The calculation for the home office deduction is based on square footage—but only the square footage used exclusively for business purposes.

A workstation set up in the living room can, for example, be deducted—but only for the square footage the workstation sits on—not the entire living room. What's more, that deduction can't be taken if the dedicated square footage is used for any non-business purpose. If, for in-

A workstation set up in the living room can, for example, be deducted—but only for the square footage the workstation sits on—not the entire living room.

Continued on page 125

Tax Audits (from page 124)

stance, the home office doubles as a guest room, no home office deduction can be taken.

Travel and Meal Expenses. Travel (not commuting), and meal expenses are legitimate business expenses, particularly if they involve meeting patients or prospects. However, higher-than-average costs in these areas can draw the attention of the IRS.

When writing off travel and meal expenses, proving they are for business—not personal—purposes is essential. Everything should be documented and receipts retained so, if necessary, a meeting's connection with the podiatric practice can be proven. Documentation should include:

• The purpose of the meeting and its connection with the practice
• Time, date and location
• A list of those attending, and
• A summary of the meeting.

Vehicle Deductions. A podiatrist using a personal vehicle for business purposes, the practice can often deduct a portion of the vehicle expenses. If the vehicle is used exclusively for business, a deduction for depreciation is often available. Unfortunately, because 100% business use is unlikely in most cases, claiming full business use of a vehicle is an audit red flag. The vehicle expense deduction should be backed up with mileage logs showing the dates and purposes of every trip.

Triggered by the Tax Pro

Far too many professionals and business owners have succumbed to the promise of big refunds when using the services of a particular tax pro. Beware, however, tax preparers have long been a high priority target of the IRS—as have many of their clients.

The IRS has a number of ways that it discovers crooked tax return preparers. One of their clients may be audited and the results could be unrealistic enough that the IRS may take a look at other returns they have prepared.

Tax return preparers use—or should use—an identification number known as a PTIN, allowing the IRS to readily and easily identify all of the returns they prepare. It should go without saying that every podiatric professional should do everything in their power to avoid them especially if they do not sign the tax returns or indicate that the return was self-prepared.

Reality Versus Triggers

In reality, no one knows which tax returns will be singled out for audit by the IRS's computer algorithms. Many so-called "triggers" have been developed through the experiences of many professionals. The proposed increase in IRS auditors may or may not impact the current audit rate that sees fewer than 2% of all income tax returns examined within a year.

The statute of limitations for an IRS examination is three years from the due date of the federal tax return or the date it was filed. This period is doubled to six years if the return reveals a substantial understatement of income, usually more than 25% of taxable income. In failure to file a return for a particular year, or if fraud is suspected, there is no time limit.

Caught, Now What?

If a tax return is selected for an IRS audit, the podiatric practice (or its principal) will receive a notice in the mail. The notice is always sent to the last known address and is never by phone, email, or social media.

If audited, it will most likely be through a correspondence audit. The letter will contain instructions about what information must be sent to them. If more information is needed, the IRS will reach out again.

Should the IRS request an in-person meeting, typically at their regional office, the notice usually contains instructions about preparing for the audit and the particular items being examined. As an alternative, Letter 2205, a shorter version of the audit notice, will request a phone call and usually prefaces a face-to-face meeting.

Unfortunately, those wishing to speak with someone about an audit are limited to calling a representative on a toll-free line. Getting through on the IRS's toll-free line has proven difficult and time-consuming.

Taxpayer Rights

The Taxpayers Bill of Rights, part of the IRS Restructuring and Reform Act of 1998, requires the IRS to provide a written statement detailing the taxpayer's rights and the IRS's obligations during the audit, appeals, and refund and collection processes.

These rights include:

• A right to professional and courteous treatment by IRS Employees.
• A right to privacy and confidentiality about tax matters.

Travel (not commuting), and meal expenses are legitimate business expenses, particularly if they involve meeting patients or prospects.

• A right to know why the IRS is asking for information, how the IRS will use it, and what will happen if the requested information is not provided.
• A right to appeal disagreements, both within the IRS and before the courts.

Among the most important of the rights given every taxpayer whose returns are targeted for an audit is whether to be represented by a tax professional, or whether to attempt to answer the IRS's questions alone. Another important consideration for everyone and every podiatric practice principal being audited is where to hold that meeting.

Should the meeting be in the accountant's office where all of the working documents are easily accessible? Should it be at the practice's place of business, the place where all the records are kept to demonstrate to the IRS auditor that there is nothing to hide and that the podiatric practice is a legitimate one? Or, should the podiatrist, the practice's manager, and/or the operation's representative trudge

Continued on page 126

Tax Audits (from page 125)

down to the IRS office armed only with the specific documents and information requested by the IRS auditor? Not too surprisingly, there is no one right answer.

Honesty and clarity go a long way toward preventing, dealing with, and surviving an IRS audit.

Lost Revenue

According to the Secretary of the U.S. Treasury, Janet Yellen, "a shocking amount of taxes are going uncollected." In an interview with The Atlantic, she said, "It's really shocking and distressing to see estimates suggesting that the gap between what we're collecting in taxes on current tax and what we should be collecting—if everybody were paying for taxes that are due—that amounts to over $7 trillion over a decade." Not too surprisingly the government is trying to make meaningful steps to close that gap which, in all likelihood will include more IRS audits.

While it is impossible to fully inoculate the podiatric practice or its principal since a portion of all audits are truly random, there are steps that can be taken to minimize the likelihood of receiving that feared notice from the IRS. Obviously, every podiatric professional should claim deductions they or their practice are legitimately entitled to. Of course, there is a need for vigilance and detailed record-keeping to defend those deductions in an audit.

Honesty and clarity go a long way toward preventing, dealing with, and surviving an IRS audit. Naturally, every podiatric professional, principal in a podiatry practice, and practice manager should have a strategy for avoiding audits as well as for dealing with an IRS auditor. A fallback position should those strategies fail should also be in place. **PM**

Mark E. Battersby is a freelance writer who has specialized in taxes and finance for the last 25 years. Working from offices in the suburban Philadelphia community of Ardmore, PA, Mr. Battersby currently writes for publications in a variety of fields, and syndicates two weekly columns that appear in over 65 publications as well as regular columns in ten fields. He has also written four books.