



A TUTORIAL ON IRS AUDITS:

Understanding the
Process, Your Rights,
and What to Expect





IRS AUDIT

Discover some simple steps to help you plan for an audit and prepare yourself to sail through unscathed.

If you are like most people, you probably shudder at the thought of an IRS audit. You imagine a long, painful, and difficult journey into your financial past or your company's financial transactions and reporting. However, when you understand the audit process, you will more likely plan for it than fear it.

If you think about it, the IRS must perform some audits to ensure tax compliance and fairness. In fact, they audit a very low percentage of returns — only .4% in 2022 — and recent reports tell us that taxpayers are half as likely to be audited as they were a decade ago. For the person or business just served notice that the IRS is going to review and examine their records, however, those reports likely provide small consolation.

If the saying, "Knowledge is power," is true, the following brief tutorial on the basics of an IRS audit should help empower you against both the prospect and the reality of an IRS audit.

Note: If you have already received notification of an audit or have reason to fear an audit, it is wise to get a tax professional involved. The experienced attorneys at [Robert J. Fedor, Esq., LLC](https://www.fedortax.com) can offer strong legal guidance.



How the IRS Chooses Returns to Audit

So, what is an audit? The [IRS describes](#) it this way—a review of an individual's or organization's "accounts and financial information to ensure information is being reported correctly, according to the tax laws, to verify the amount of tax reported is accurate." The IRS notes that just because you must undergo an audit "does not always suggest" that you have done something wrong or made grievous mistakes.

The IRS selects specific returns for audit based on various factors:

- ✓ **Dependent Database Program (DDB):** The primary system the IRS uses, an automated system that flags returns with potential risk of noncompliance. The DDB is continually reviewed to ensure accuracy.
- ✓ **Document-Matching:** If the information on certain forms, such as W-2s or 1099s, doesn't match other data the IRS has on file, this discrepancy may trigger an audit.
- ✓ **Connections to Other Audited Parties:** If someone you engage with in business—such as a partner or investor—is being audited, the IRS may review your records to assess whether your finances reveal relevant information about their accounts, or vice versa.
- ✓ **High-Risk Industries:** Certain industries or professions, such as cash-based businesses, are more prone to audits due to higher risks of noncompliance.
- ✓ **Unusually High Deductions:** Large or unusual deductions in certain categories (e.g., charitable donations, travel expenses) that significantly exceed typical amounts for similar income levels may raise IRS flags.
- ✓ **Random Selection:** Occasionally, the IRS selects taxpayers for audit purely at random, regardless of specific red flags or connections.



Types of IRS Audits: From Correspondence to Field Audits

If you are selected for an audit, the IRS will choose one of three methods for your examination:

1 Correspondence Audit

Most audits are conducted via correspondence using mail and/or fax. You will be asked to provide certain documents. You will have little or sometimes no contact with the examining agent other than through your correspondence. In general, a correspondence audit is used when the IRS believes any problems can be easily reconciled without an in-person examination. You may be asked to provide essential information to verify your tax return data, such as employee or moving expenses, alimony, and casualty losses.

2 Office Audit

You or your representative will be required to meet face-to-face with the examining agent, usually at the local IRS office. These types of examinations are generally specific in nature and will likely cover only a handful of items on your return that the IRS has pre-selected. Office audits usually indicate multiple issues for which a correspondence audit would be cumbersome and/or inadequate. You should consider engaging an experienced tax attorney for an office audit.

3 Field Audit

The field examination indicates complex issues that need to be resolved and will entail an extremely thorough review of your records. It will be conducted on-site at your place of business or at your representative's office. You are advised to consult and retain an [experienced tax controversy attorney](#) if you have been selected for a field audit.



Who is at Risk for an IRS Audit?



The IRS does audit individual tax returns every year. The good news is that they only audit roughly less than 0.5 percent of all tax returns filed by taxpayers. How do you know if you are at risk of being audited?

The IRS has limited resources. They want to use those resources where they have the strongest likelihood of finding errors. They have identified certain factors as red flags for potential underreporting that may trigger an audit. For example:

✓ **Reporting more than \$10 million in income.**

A tax return on an income of \$10 million will likely have more deductions, more schedules filed, and more complexity than a return on an income of \$100,000—and therefore, more opportunities for mistakes in reporting. They want to maximize the money that may be owed to them for their efforts.

✓ **Reporting no income at all.**

Most taxpayers have some income, even if a few dollars here and there for dog walking or some similar activity. Especially when the taxpayer had income in the previous year, a return reporting no income stands out.



✓ ***Filing an estate tax return with assets worth more than \$5 million.***

Again, the potential dollar amount is significant. Estate taxes tend to be more intricate with more opportunity for different interpretations.

✓ ***Filing an international tax return.***

Many people use [offshore accounts](#) to protect wealth, requiring them to file an FBAR and opening up another possibility of non-compliance.

✓ ***Being self-employed.***

Self-employed people may take business deductions in error, often because they do not clearly understand what they are entitled to.

✓ ***Claiming a lot of deductions.***

The IRS can gauge by the taxpayer's reported income the extent and type of deductions that are normal. When the number, type, or size of deductions fall well outside the normal parameters, that return has a greater likelihood of being flagged.

An audit can be difficult to understand and can have serious repercussions if you have made any mistakes on your tax return. Even though a majority of tax returns will not be audited by the IRS, tax returns with any of these red flags will increase your odds of having the IRS audit yours.





The IRS Audit Process: What to Expect Step by Step



➤ STEP 1: **The IRS Letter**

The audit process begins with notification via an IRS letter that your return has been selected for examination. The letter will specify the year or years that are being examined and will contain contact information for the Revenue Agent who is conducting the audit. According to [IRS Publication 556](#), "the IRS makes the final determination of when, where, and how the examination will take place."

NOTE

The IRS will notify you *only by mail*, never by telephone. If you receive an audit notification other than by mail, it is a scam.



> STEP 2: **Preparation**

To prepare for the audit process, you will need to assemble and organize all documents that may be pertinent to your tax return, such as:

- ❶ **Legal documents** — civil records regarding divorce, property, or business matters; records related to criminal allegations or investigations
- ❷ **Receipts** — bills, receipts, and records of canceled checks (organize by date and note their relevance)
- ❸ **Evidence of loss** — insurance documents, legitimate appraisals, and police reports of any theft or significant loss you may have suffered
- ❹ **Banking documents** — financial documents and statements, along with detailed loan documentation (including loans not made from traditional financial institutions) and the terms, purpose, and names of those involved in any transactions

> STEP 3: **The Examination**

The examination begins with a request from the examining agent for specific documentation. Regardless of which type of examination has been selected for you (correspondence, office, or field), provide that documentation and only that documentation. Overloading the agent with unrequested documents may delay the resolution of issues and may also lead the agent to suspect other problems.

During office and field examinations, the agent may ask you questions. Answer them honestly and completely to the best of your ability. If you have chosen not to engage an experienced tax audit attorney and suddenly feel as though you made a mistake in not doing so, you may request an attorney at any time during the examination. At that point, the agent must suspend the examination. Of course, you will have to resume the examination with the agent and your attorney sometime later.

> STEP 4: **The “30-day” Letter**

After the agent has finished reviewing your return, including all the documents and explanations that you provided, the IRS will issue a “30-day” letter containing the agent’s proposed changes for each tax year, along with reasons for adding or disallowing items.



> STEP 5: **Concluding the Audit**

Based on the “30-day” letter, the audit will conclude in one of three ways:

1

If the IRS proposes no deficiency, meaning you have substantiated all the reviewed items, the audit has ended, and you owe nothing more.

2

If the IRS proposes a deficiency and a balance due, and you agree, you can sign an agreement allowing the IRS to assess and collect the deficiency, ending the audit.

3

If the IRS proposes a deficiency and a balance due, and you do not agree, the “30-day” letter will explain the process for you to appeal their findings.

> STEP 6: **The Appeal**

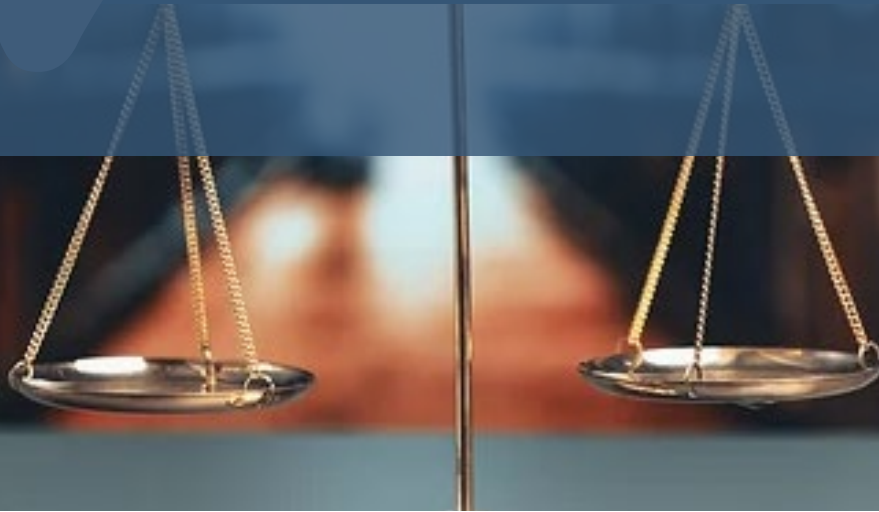
If you choose to appeal, the “30-day” letter gives you 30 days to file an appeal with the IRS Office of Appeals, which will hear each position and do one of the following:

- ✓ Rule in your favor.
- ✓ Rule in favor of the IRS.
- ✓ Work to reach a settlement. If you agree to a settlement, you will be required to sign an agreement that permits the IRS to assess and collect the agreed amount.

If you do not respond to the “30-day” letter, lose at appeals, or cannot reach a settlement, the IRS will issue a Statutory Notice of Deficiency. This notice is a formal report of the agent’s proposed changes for each tax year and is required by law before the IRS can unilaterally assess and collect the deficiency. At this point, you have one appeal left before having to pay the deficiency. You have 90 days from the date on the Statutory Notice of Deficiency to appeal your case to the United States Tax Court for reconsideration of the proposed deficiency. If you choose to appeal your case to the United States Tax Court for reconsideration and you have not yet engaged an experienced tax resolution attorney, you should do so before proceeding to that Court.



Your Rights as a Taxpayer: Protections You Should Know



Understanding your rights as a taxpayer is just as important as understanding the audit process and your obligations. Remember, being audited does not mean you necessarily did something wrong. The auditing agent is not conducting a criminal interrogation, just an exchange of information. Your rights include:

- ✓ ***Being treated courteously and respectfully*** — The auditing agent should never become belligerent or act unprofessionally, and you should report any such behavior to the agent's superior. Of course, you must also treat the agent with courtesy and respect.
- ✓ ***Having an attorney present*** — Even if you do not begin an office or field examination with an attorney at your side, you can request at any time during the examination that one be present. At that point, the agent must suspend the examination (to be resumed later when you have an attorney).
- ✓ ***Being properly informed*** — The agent must inform you of exactly what documents you are required to provide and any applicable tax law.
- ✓ ***Appealing the IRS' decision*** — As you learned in the previous section, you have multiple opportunities to appeal the IRS's decision.

You have many other rights, such as the right to privacy and the right to confidentiality. All your rights are spelled out in the [Taxpayer Bill of Rights](#). If you receive an audit letter, you will find it helpful to review the entire Bill of Rights before proceeding.



Business Audits: Special Considerations for Small Business Owners



Individuals in the U.S. are afforded many opportunities and freedoms, including those that relate to commerce. According to the U.S. Small Business Administration, there are roughly 30 million small businesses in the U.S. and small businesses account for roughly 54 percent of annual U.S. sales.

While U.S. small business owners are certainly provided with opportunities to start and grow a business, they are also subject to many federal and state rules, laws, and regulations including those imposed by the IRS. Small business owners may be singled out for closer review or an audit.

If you have a business that receives an IRS audit letter, you should consider engaging an experienced tax audit attorney to help you. If you have concerns that you may be in violation of the tax code or that an audit may result in the discovery of evidence that could lead to criminal charges against you, you should contact a criminal defense attorney immediately.



The following are examples of records an IRS auditor will review that could potentially raise red flags and result in IRS fines, penalties, and even criminal charges. You can protect yourself and your business proactively by meticulous, accurate record-keeping.

1

Cash transactions

If your business is primarily cash-based, be prepared to show detailed financial records to account for earned income and paid taxes.

2

Payroll taxes

The Internal Revenue Code does not provide a specific definition of the difference between an employee and an independent contractor. However, the IRS typically applies a three-prong test to classify workers:

- a. The behavioral control of the worker by the business
- b. The financial control of the worker by the business
- c. The contractual and control relationship between the parties

NOTE

Although the use of these guidelines tends to be highly subjective among different examining agents, you can use these guidelines to help you make the right classifications.

3

Business-related deductions and expenses

Are you writing off a significant dollar amount of business-related expenses?
Are you able to produce detailed records of these expenses?

4

Lifestyle considerations

In cases where a business is operating in the red on paper and a business owner lives in an expensive home or drives an expensive car, he or she should be prepared to answer questions about such discrepancies.



Common Audit Outcomes: How an Audit Can Affect You

As noted earlier, an IRS audit can end in several different ways. But how will they affect you? Let's take a look:

- If the IRS examination results in no discrepancy—congratulations. You likely have kept good records and completed your return properly. Depending on the type of audit, you have spent time and probably felt some level of anxiety. Use the experience to learn what, if anything, you can do to avoid or prepare for an audit in the future.
- Similarly, if the IRS finds a discrepancy in your return and you choose to pay it and end the audit, you will likely have learned some things that can help you in the future.
- If you choose to appeal the IRS finding of a discrepancy, you will invest quite a bit of time and energy (and, perhaps, money), whether or not you win your appeal, especially if you take it all the way to the Tax Court. You may enjoy the satisfaction of winning your appeal, or you may lose and have to pay.
- If you fail to respond appropriately to the initial IRS letter, provide false or misleading information, or otherwise violate civil or criminal statutes, you may find yourself assessed with financial penalties or, in the worst case, charged with a crime. None of these negative outcomes is as likely to happen if you cooperate fully with the agent and particularly if you seek the counsel of an experienced tax audit attorney.
- On a more positive note, there is one more possible outcome. Upon examination, the agent may find that you made an error (or errors) in favor of the IRS. In that case, you will get money back (or more money back if you were due a refund).



Individualized representation from the attorneys at Robert J. Fedor, Esq., L.L.C. **can protect you from the possibility of civil or criminal penalties.**

Protecting Yourself: What You Can Do to Avoid and Prepare for an Audit

Why wait for an audit letter? Start now to reduce your audit risk and prepare yourself should you be audited:

- ✓ Keep meticulous records. Save receipts, legal documents, appraisals, and any other financial documents you may need to validate your return. Make sure all your records are organized so that you can access what you need when you need it.
- ✓ Look at your expenses, payroll (if you own a business), and other possible items you will include in your return from the point of view of the IRS. Anything you can do ahead of filing to make such entries seem compliant and reasonable will accrue to your advantage.
- ✓ When you file your return, double-check your math. If you make mistakes in computation, the IRS will be alert for others.
- ✓ If you fill out your own return, remember that neatness counts. If the IRS cannot read something, they may want an explanation.

If you do receive an audit letter, consider hiring an experienced tax attorney. Not only will you reduce your stress level, but you'll also shield yourself from potential civil or criminal penalties. [The knowledgeable tax attorneys at Robert J. Fedor, Esq., L.L.C.](#) support clients all over the country during and following IRS audits. The findings of an agent never have to be the final verdict. We can help with your appeal of an often-costly decision.

Attorneys & Counselors at Law

Robert J. Fedor Esq., LLC 