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How Low IRS Audit Rate Could Actually Hurt You

The IRS has confirmed that tax audits are way down, caused by budget cuts and fewer IRS personnel. In fact, the number of audits dropped 16% just from the previous year, and that was the sixth year in a row for fewer audits. The chances of audit have always been low, but they have gotten even lower, considerably less than 1%. That makes for a lot of happy taxpayers. No one wants to be audited.

Even if you think you've reported everything and done it properly, having to produce receipts and reasons for what you did can be maddening, or worse. The IRS is trained to find *something* you did wrong, right? The IRS has long complained about budget cuts, and the IRS has lost more than 17,000 employees since 2010. The IRS is now auditing only 0.84% of individual taxpayers. That's less than 1 out of 100, and the rates are falling. An audit might be in person or by correspondence, but there is presently a small chance of either.

With all this taxpayer-friendly news, how can infrequent audits hurt you? Think of it like knowing that there is only one police officer in your state to give speeding tickets. Would you be more likely to speed? You might take liberties and drive dangerously. In the same way, low IRS audit rates are likely to embolden some taxpayers and tax advisers. They may feel that they are in the clear. Statistically speaking, they might be. But *someone* is going to get audited. And you should prepare as if you will be audited, not assuming that you will not be.

If you are fully prepared for an audit, with documentation, receipts, log books, perhaps even a tax opinion, you probably won't need them! That is the odd karma about being prepared. Conversely, suppose you figure that you don't need any of those things, and can produce them if and when you are audited? You guessed it, you probably will get audited. What's more, you won't be able to quickly produce all the things you think you can.

Even if you do, the documents will almost certainly be much less persuasive to the IRS than contemporaneous ones would be. And a tax opinion prepared at audit time is rarely entitled to much deference! In short, prepare up front and assume that you'll be audited. How long are you at risk? Start with the basic rule that the IRS *usually* has three years after you file to audit you. But this is often extended, sometimes voluntarily. Frequently, the IRS says it needs more time to audit. The IRS asks you to sign a form extending the statute, usually for a year. Most tax advisers tell clients to agree, but get some professional advice. You may be able to limit the time or scope.

An exception to the three year rule is if you omit more than 25% of your income. In that case, the IRS gets double that time, six years. The IRS also gets six years to audit if you omitted more than $5,000 of foreign income (say, interest on an overseas account). For unfiled tax returns, criminal violations or fraud, the IRS has no time limit. In most criminal or civil tax cases, though, the practical limit is six years. And in some cases, even if you file your return, if you miss some tax forms, the IRS can audit forever.

The statute of limitations on taxes is a fundamental rule allowing taxpayers to cut off their exposure. You should never throw out your old tax returns—ever. But after a time—many people say seven years or so—you *should* be able to throw out records and receipts. Still, some records should be kept forever—like receipts for improvements to property that go into your basis. If you remodel your kitchen and sell your house 20 years later, the receipts for your remodeling job are still relevant. It is comforting to know that your chances of an IRS audit are declining. But *someone* will be audited, and you might be the one. The best way to avoid much of the pain is to be prepared.

For alerts to future tax articles, email me at Wood@WoodLLP.com. This discussion is not legal advice.