

August 31, 2012

Internal Revenue Service and Franchise Tax Board Audits on the Rise

Navolio & Tallman LLP and colleagues from other CPA firms have witnessed a large increase in the number of audits of wealthy individuals and small businesses over the past year. In the near future, we also expect a higher rate of gift and estate tax audits due to the recent hiring of IRS auditors and the decreased number of estate and gift tax returns to be filed each year.

What are the chances that you may be audited?

- 18% of U.S. taxpayers in the highest tax bracket were audited in 2011
- The audit rate has increased 63% over prior years

What are the common issues under investigation?

- Large itemized deductions, such as mortgage interest and charitable gift deductions
- Employee business deductions
- Aircraft-related expenses and deductions
- Rental properties, especially for individuals identified as real estate professionals
- Passive versus non-passive treatment of deductions

What types of audits are conducted?

- Office audit – The auditor provides an appointment time and asks you to bring certain records to the auditor's office.
- Field audit – The auditor comes to your place of business or to your tax adviser's office.
- Correspondence audit – Approximately 70% of audits for individuals are correspondence audits. The entire audit is handled through an exchange of letters and documentation.

The audit process can often span over a 6 to 12 month period, as audit requests tend to include lengthy lists of detailed questions and requests for supporting documents, and taxpayers are required to submit documents over the course of the audit. Compliance with such audit requests is usually time consuming and expensive.

In order to come out of an audit with little or no adjustments, we highly recommend that you maintain *sufficient* records that support your tax returns. Sufficient records can range from receipts (for medical expenses, contributions, or business expenses) to calendars and log books to show your level of participation in rental or business activities or details of meetings to support the deductibility of certain expenses. All of the audits that we have encountered require ***substantiation of expenses and deductions*** that go beyond a copy of a cancelled check and a bank or credit card statement. Without valid supporting documents, expenses and deductions claimed on your return may be fully disallowed and cause a significant **increase in your tax liability, plus penalties and interest.** All supporting documents should be retained by you indefinitely, or as long as there is a possibility that you could file an amended tax return or that the IRS or FTB could assess additional taxes.

In light of increased scams and phishing activity, please be aware that taxing authorities do not use email to correspond. **Do not give out your personal information** (via email or over the phone) to anyone you do not know, even if that person identifies himself as a revenue agent. If you receive a phone call or a notice from any taxing authority, please notify us immediately so that we may verify and resolve the issue for you. You will need to sign a *Power of Attorney* authorizing Navolio & Tallman LLP to represent you in your audit.

With over 40 years of combined experience handling IRS and FTB audits and knowledge of real estate firms, high-net-worth individuals, and small businesses (including small business stock), Navolio & Tallman LLP can guide you through your audit to a successful outcome.

Please contact us if you have any questions.

Any tax advice in this communication is not intended or written by Navolio & Tallman LLP to be used, and cannot be used, by a client or any other person or entity for the purpose of (i) avoiding penalties that may be imposed on any taxpayer, or (ii) promoting, marketing, or recommending to another party any matters addressed herein. With this newsletter, Navolio & Tallman LLP is not rendering any specific advice to the reader.