GROWERTALKS

Features

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Avoiding Tax Audits

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While the IRS's own figures reveal that, in general, only 1% or 2% of all taxpayers actually have their returns audited each year, the threat of an audit continues to strike fear into every business owner. 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. 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.

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. The result is that many businesses are being scrutinized far more often than the numbers indicate.

Although the IRS takes a dim view of overstated deductions, something such as a failure to report income can result in stiff penalties. And then there's 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 aren't big.

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 & 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's 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 everyone can take to reduce the risk of your business becoming an audit target:

• 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

• Don't report a loss—never report a net annual loss for any business

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

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 the business earned and what was reported. Consider several other potential red flags:

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

Cash transactions go unreported by many who still 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 grower/retailers 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.

A business 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 your operation shouldn’t use independent contractors just to 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 growers 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 business.

The home office: With many taxpayers shifting to "work from home" during the pandemic, it should come as no surprise that the home office deduction will be under extra scrutiny. The calculation for the home office deduction is based on square footage, but only the square footage used exclusively for business purposes.

Travel and meal expenses: Travel, not commuting and meal expenses are legitimate business expenses, particularly if they involve meeting customers 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 business can be proven.

Triggered by the tax pro: Far too many growers have succumbed to the promise of big refunds when using the services of a particular tax pro. Beware, however—tax preparers have been a high priority target of the IRS for years … as have many of their clients.

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. Failure to file a return for a particular year, or if fraud is suspected, there is no time limit.

Caught—now what?

If audited, it will most likely be through a correspondence audit. The letter will contain instructions regarding what information must be sent to them.

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.

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, refund and collection processes.

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 business owner being audited is where to hold that meeting.

Not a lost cause

While it's impossible to fully inoculate the business or its owner 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, everyone should claim deductions they or their growing operation are legitimately entitled to. Of course, there's 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 greenhouse grower 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. **GT**

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