

# Audits

## ARROWHEAD TAX SERVICE

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### Representation

Individual taxpayers who are under audit by the IRS may attend the audit in person without any assistance from a tax professional. However, this can be a dangerous mistake. Although not officially stated, it is the job of an IRS Revenue Agent to conduct an audit with an eye toward finding additional tax owed. With so many gray areas in tax law, and considering the tax code's complexity, an individual who chooses to go it alone is a sitting duck. With extensive tax education and experience, the examiner can take a position to find additional tax due on the return. Without the necessary knowledge, the taxpayer is powerless to refute the agent's rationale.

### Selection of Returns for Examination

#### Search for Unreported Income

The IRS performs matching functions to reconcile information reported on Forms 1099 and W-2 with information reported on your return. If income reported by you does not meet or exceed amounts reported to the IRS, you will receive either a bill for tax on the difference or an audit notice.

#### Worker Reclassification Efforts

The IRS conducts employment audits to determine whether workers classified as independent contractors are in fact employees.

#### Schedule C (Form 1040), Profit or Loss From Business

Issues associated with sole proprietorships are common audit triggers. The IRS has several approaches to achieve an increase in income tax, as well as the assessment of self-employment tax.

- **Unreported income.** There is a relatively high potential for unreported income from cash transactions with sole proprietorships. The IRS will examine your bank records to detect deposits that are unaccounted for, compare revenue and expenses of similar businesses, and in some cases will perform a "lifestyle" audit to reconstruct income based on changes in the sole proprietor's net worth.
- **Losses.** Significant losses reported on Schedule C, or losses continuing over two or more years, may increase the chance of audit. If the IRS is successful in reclassifying an activity as a hobby instead of a for-profit business, losses will be disallowed.
- **Bartering.** The fair market value of products and services received through bartering can be considered business income if the products or services rendered are associated with the sole proprietorship. If the sole proprietor trades through a barter exchange program, the program will issue Form 1099-B, *Proceeds from Broker and Barter Exchange Transactions*.

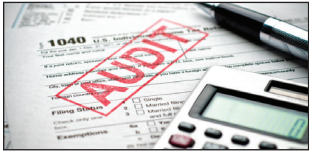
### Audit Procedures

#### Examination by Mail

**Notice CP 2057.** The CP 2057 notice informs you that there appears to be an income discrepancy on your return. The notice instructs you to review the return and file an amended return to correct the information, if necessary.

**Notice CP 2000.** A CP 2000 notice from the IRS proposes changes to your tax return based on information the IRS has received from third party sources (i.e. Forms W-2, 1099-INT, 1099-MISC, etc.) that the IRS believes has not been reported on your return. You typically have 30 days to respond to the IRS with one of three options.

- To agree with all the proposals.
- To partially agree with the changes.
- To dispute all the changes proposed by the IRS.



# Audits

You are allowed to sign an authorization that enables another party to represent you in connection with the Notice CP 2000. The authorization is part of Notice CP 2000, and a separate power of attorney is not required.

## Field Audit

The revenue agent will send a letter to you requesting that you phone the agent. At that time, the date, location, and agenda for the first meeting will be set. You have the right to request that the examination take place at a reasonable time and place that is convenient for both you and the IRS.

## Audit Strategy

The best way to prepare for an audit is to put oneself into the auditor's shoes. Take the perspective that you are looking for anything possible to increase the tax liability on the return. This is an area where a qualified tax preparer can be invaluable.

Ask yourself tough questions and be prepared to support any questionable deductions. Make sure any issue raised during an audit is something that has already been considered. If the pre-audit function is performed properly, the actual audit will be more comfortable, and you will be prepared for any negative adjustments.

When conducting an audit, the IRS will ask you to present documents to substantiate the income, deductions, and credits claimed on your tax return. The documentation should be organized by year and the type of income or deduction.

## Audit Video

The IRS has created a video web page to assist taxpayers preparing for a small business audit. Go to the IRS website at [www.irsvideos.gov/audit](http://www.irsvideos.gov/audit).

## Appeals

If you disagree with the IRS proposed changes, you can appeal the results of the examination in one of the following ways.

- For examinations taking place in an IRS office, you can request an immediate meeting with the examiner's supervisor.

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- Use mediation services offered by the IRS.
- Appeal to the local IRS Appeals Office.

## Take It Seriously

Any comments made to an IRS employee that could be interpreted as a threat against the employee will be taken seriously and fully investigated. Do not joke around with IRS employees during an examination.

## Repeat Examinations

If a return was examined for the same items in either of the two previous years, and no change was proposed to the tax liability, contact the IRS immediately and the examination will likely be discontinued. This policy is in accordance with IRC section 7605(b), which states that no taxpayer shall be subjected to "unnecessary examinations."

## End of an Audit

### No Change Letter

If the return is accepted as filed, the IRS will issue a "no change letter," and no further action is required.

### 30-Day Letter

In an unagreed case, the IRS will issue a "30-day letter." You are given the option of agreeing with the proposed changes and also given information about protesting and appealing the results of the audit.

### 90-Day Letter

If you do not respond to the 30-day letter, the IRS will issue a statutory Notice of Deficiency which allows you 90 days to file a petition to the Tax Court or pay the tax and file a claim for refund.

## Contact Us

There are many events that occur during the year that can affect your tax situation. Preparation of your tax return involves summarizing transactions and events that occurred during the prior year. In most situations, treatment is firmly established at the time the transaction occurs. However, negative tax effects can be avoided by proper planning. Please contact us in advance if you have questions about the tax effects of a transaction or event, including the following:

- Pension or IRA distributions.
- Significant change in income or deductions.
- Job change.
- Marriage.
- Attainment of age 59½ or 72.
- Sale or purchase of a business.
- Sale or purchase of a residence or other real estate.
- Retirement.
- Notice from IRS or other revenue department.
- Divorce or separation.
- Self-employment.
- Charitable contributions of property in excess of \$5,000.