What Are the Chances of My Being Audited by the IRS?

By Phyllis Horn Epstein

My son's scariest Halloween costume was a T-shirt bearing the words "IRS Audit Agent." An audit can be a terrifying experience. The prospect of defending everything that you have sworn was true on your income tax return and justifying everything you left off is not only disruptive but potentially expensive. So, what — we might ask — are the chances of being audited?

Number of Audits in the U.S.

The rate of audit has been in decline for at least a decade. In 2021, the audit rate for all taxpayers was .4%, down from .9% in 2009. To be more specific, in 2021 the total number of audits was 659,003 out of 160,077,451 filed individual returns. However, the audits that do occur do not equally impact all taxpayers. Notably, the audit rate for individuals below the poverty line in 2021 was more than three times the overall average and more than five times the rate for all taxpayers above the poverty line.


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One reason for the disparity of audit rates is that, presently, the IRS is hampered in auditing the returns of higher net worth individuals and corporations because of a lack of resources. Tax issues that generate audits for lower income taxpayers are generally more straightforward, less complex and involve eligibility for tax credits. Wealthier taxpayers and corporations have more complex tax returns. According to IRS Commissioner Charles P. Rettig, “The number of examining revenue agents, who handle complex enforcement cases, fell by 35%, and field collection revenue officers, who manage difficult collections cases, dropped by 48%.” Testifying before the House Ways and Means Committee in March 2022, Commissioner Rettig virtually waved a white flag of defeat in the face of corporate audits. He admitted that the IRS is “outgunned” in being able to audit a “respectable percentage of large corporations” that “can afford to spend large amounts on legal counsel, drag out proceedings and bury the government in paper.”

In recent years, the IRS has relied on correspondence audits, those conducted solely by mail, as they require fewer IRS resources. In 2021, 85% of all tax audits were correspondence audits and more than half of those were against taxpayers with less than $25,000 in income claiming the earned income tax credit (EITC). Simply put, auditing low-income taxpayers by correspondence audit is cheaper and easier for the IRS. The IRS has reported that most correspondence audits can be performed in under five hours, without human intervention and at a cost of just $150.

To increase tax enforcement at other income levels, the IRS created the Office of Fraud Enforcement in 2020 and has set about hiring additional agents to turn around the decline in revenue agents experienced in the last 10 years. Unfortunately, more tax examiners than revenue agents have been hired in recent years. Tax examiners are generally less experienced and less capable of handling complex audits — the type of audits that apply to higher net worth taxpayers.

Today, the likelihood of being audited is not very great, but some taxpayers are more at risk of audit than others, based upon income, geography and issue reporting.

What Can Increase Your Risk for Being Audited?

Selection for an audit does not always suggest there's a problem. There are several reasons why your tax return may stand out and become one of the thousands open to audit scrutiny.

- **Random Selection and DIF Scores**. Sometimes returns are selected based solely on a statistical formula. With an eye toward greater computerization, the IRS developed formulas, known as UI-DIF, short for Unreported Income Discriminant Function, to evaluate which returns should be selected for audit. The IRS does not have to disclose how it figures which cases to audit, and the actual criteria for generating a DIF score remains an IRS secret. However, the factors used to score a return generally mirror a tax return so that the IRS can rate, in retrospect, what issues are best placed under exam. Underlying this seemingly random method of selection is the process of comparing certain "norms" or expectations to a random sample of returns.

- **Frivolous Returns.** The IRS classifies certain tax return positions as "frivolous" and can assess extra related penalties. The list of frivolous positions is published and extensive, so if you claim that the tax system is unconstitutional and the government has no tax collecting authority, prepare to be audited and have penalties assessed.

- **Related Examinations.** You may get pulled into an audit if, for example, your business partner is undergoing one. The transactions that tie you to other taxpayers may suddenly involve you in a wider-scale investigation. Investors in tax shelters may wind up in an audit where the shelter itself is under review.

- **Income at the Poverty Level.** As noted earlier, the odds of being audited increase for those with an annual income under $25,000. These taxpayers typically claim the EITC anti-poverty credit, which makes them more susceptible to review. And contrary to the trend of a decline in audit rates, for those with adjusted gross income between $1-$24,999, the audit rate percentage has increased.

- **High Income and High Net Worth Nonfilers.** In 2020, the IRS began to focus on taxpayers who had more than $100,000 in income and had not filed a tax return before 2019. Since then, more revenue agents have been tasked to bring these nonfilers into compliance. Depending upon the situation, these cases may be referred to the Office of Fraud Enforcement within the Small Business/Self-Employed Division of the IRS or the IRS Criminal Investigation Division for Tax Evasion and Tax Fraud.

Overall, those who had a positive income of more than $1 million were audited at a rate of 2.2% in 2021. Statistics from 2018 show that those earning more than $10 million annually were audited at a rate of 5.3%. The IRS commissioner asserted in his testimony that he has targeted this demographic with 6,500 trained agents and that the high income net worth taxpayers in this group make up a large percentage of the 4.2 million complex partnership returns filed in 2021 that compel audit attention.

On the other hand, in 2021, there were nearly 9 million taxpayers with positive income between $200,000 and $1 million, and fewer than 40,000 of these returns were audited — or .45%. Similar to the general trend, the audit rate for this group of taxpayers has declined since 2010 when it was 2.9%. The lower audit rate for this group has been explained by Commissioner Rettig as being caused by the increased information reporting for these taxpayers through

1099 and W-2 forms, which allow for more computer matching of income and reporting rather than personal audit.

• **Virtual Currency.** The IRS, through its Criminal Investigation Cyber Crimes Unit, is focused on tax avoidance through virtual currency and related crimes. The IRS has targeted darknets, which provide web anonymity, for child exploitation operations, international money laundering operations and virtual currency theft and terrorism financing sites maintained on behalf of al-Qaida and Hamas, for example. A new question appears on the tax forms 1040, 1040-SR and 1040-NR this year asking you to disclose whether you received sold, exchanged or otherwise disposed of any financial interest in virtual currency. Failure to check the box in answer to this question will cause a return to be either rejected if e-filed or will result in a written request for correction if filed by mail.

• **Failure to File.** The IRS can track nonfilers by collecting information from various third-party sources, including 1099s and W-2s. In addition, the IRS may gather information from its whistleblower program, from U.S. Attorney offices, from investigations by other law enforcement, from individual tips and from tax treaties. Eric Hylton, then-commissioner for the IRS Small Business/Self-Employed division, was quoted as stating: "[R]est assured, we will continue to identify and contact noncompliant taxpayers, offer payment options and hold those who refuse to comply accountable."

• **Claiming the EITC Credit.** The EITC is a refundable credit and an anti-poverty measure for working families introduced by the Tax Reduction Act of 1975. The credit is claimed on the income tax returns of those who are eligible based upon earned income. While the average credit is $2,500, the highest credit for 2021 is $6,728 for working taxpayers with three or more children. Use of the credit does not require documentation or proof of eligibility on a tax return and, as a result, most EITC audits are primarily focused on eligibility.

Statistically, more EITC audits are conducted in Southern states. The top three impacted states are Mississippi, Louisiana and Alabama, with more than 2% of all EITC claims subject to exam. The IRS claims that geography is not an audit triggering factor, and it reasons that populations in those named states "may be disproportionately low-income and minority."

By all accounts and available testimony before Congress, nearly all EITC audits are correspondence audits and most correspondence audits are because of claims for EITC. Approximately 330,000 EITC returns are audited annually. In defense of increased auditing, the IRS Commissioner has noted that 50% of EITC claims have errors and result in billions of dollars of improper payments. On the other hand, a National Bureau of Economic Research study showed that 85-90% of EITC audits result in a change, either because of circumstances relating to taxpayer eligibility or more often by default because of the inadequacies of correspondence audits resulting in undelivered mail or a lack of response.

• **Filing an Amended Return.** Filing an amended return increases the opportunities for audit but doesn't seem to trigger audit selection. As noted on the IRS website: "[F]iling an amended return does not affect the selection process of the original return. However, amended returns also go through a screening process and the amended return may be selected for audit."

• **Claiming a Refund.** The IRS website asserts that "a refund is not necessarily a

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trigger for an audit." Emphasis on the word "necessarily"!

- **Specific Areas of Interest to the IRS.** Many new IRS compliance initiatives are issue oriented rather than taxpayer centric, with "a focus on those issues that have been determined to present significant risk of noncompliance." There are 53 current, active, issue-oriented campaigns within various divisions of the IRS. New campaigns are announced each year. On Feb. 7, the IRS Large Business and International Division added a new campaign focused on Partnership Losses in Excess of Partner's Basis Campaign. For the full list of audit campaigns, check out the IRS website.

- **Large Partnership Audits.** The new Large Partnership Compliance Pilot Program is an indication that the IRS intends to bring new audit attention to large partnerships in excess of $10 million in assets as a result of the new centralized audit process enacted as part of the Bipartisan Budget Act of 2017 (BBA). The BBA gave the IRS more leeway to assess and collect tax from partners rather than their partnerships.

- **Compensation of Officers in S-corporations.** Another new focus of IRS audits is the compensation of officers of S-corporations. The issue of compensation can arise during an exam of the corporate tax return (Form 1120-S), an employment tax audit or because of IRS Compliance Initiative Projects. Often, officers of S-corporations fail to take a salary to avoid paying employment taxes. The Treasury Inspector General for Tax Administration (TIGTA) issued a report in August 2021 specifically highlighting this problem and urged the IRS to do a better job of auditing these returns. According to the TIGTA report and the IRS Data Book for 2020, fewer than 1% of all S-corporations are selected for examination. Further, between 2016 and 2018, there were 266,095 returns with profits greater than $100,000, a single shareholder and no officer's compensation that were not selected for a field examination, resulting in a multi-billion-dollar loss of employment tax. The TIGTA report suggests that the issue of officer compensation should be mandatory for field examiners and that the IRS should apply the random/automatic analysis for auditing using DIF scores to all 1120-S returns. In the future, this may become one of those issues that is likely to trigger an audit.

- **Tax Shelters.** In April 2021, the IRS announced a new Office of Promoter Investigation for the purpose of "continuing our increased focus on promoters of abusive tax avoidance transaction. ..." Specifically, according to the IRS commissioner, the IRS intends to pursue those who "promote and make use of abusive tax shelters, and [we] are especially concerned about certain variations, including abusive syndicated conservation easements and micro-captive insurance shelters."

- **Audit Guidelines.** The IRS publishes several Audit Technique Guides for revenue agents, which is some indication of IRS interest in various taxpayers and issues, including: attorneys, child care providers, nonqualified deferred compensation, real estate property foreclosure and cancellation of debt. Each booklet offers a window into IRS thinking. For example, the Business Consultants Audit Techniques Guide encourages an IRS agent to explore whether the taxpayer has engaged in tax avoidance through bartering. Agents are urged to look for any Forms 1099-B (Proceeds from Broker and Barter Exchange transaction), to check the taxpayer's website and links, look at memberships, credit cards and achievement awards. A taxpayer's profile may become a factor in whether there is an audit based upon his or her own activities or activities linked to others who may be subject to audit.

Tax Return Mishaps That Can Result in Rejection or Other Scrutiny

The IRS will sometimes reject a tax return as filed or set aside a return where the numbers entered conflict with other third-party information reports. For example, if your 1099 interest statement from your bank shows $150 of interest earned and you report only $75, your return will be open for review. Sometimes a form is missing, or you may misstate your filing status. Not everyone is of the view that this cross-checking is the same as a full-blown audit; however, it does initiate a review of someone's return and can lead to a larger audit investigation. Nina Olson, former National Taxpayer Advocate, characterized these examinations as "unreal" audits because they don't result in an examination of the taxpayer's records. These types of reviews are based solely upon the reporting on the tax return.

- **Math Errors.** The IRS will cross-check each return against third-party reporting to be certain, for example, that income reported as wages on a return matches income reported on an employer's Form W-2. This is done through the Automated Underreporter Program. According to the IRS: "Math errors include a variety of conditions such as computational errors, incorrectly transcribed values, omitted entries, failure to meet eligibility requirements, claims that exceed statutory limits and insufficiently supported claims, which are identified during the processing of tax returns." This is a fairly comprehensive list of misdeeds that stall the smooth processing of a tax return. In 2020, the IRS issued 1.2 million math error notices.

Math Error Avoidance. The IRS has set out in IR-2022-62 "Easy Steps" to avoid math errors on a return.

• File electronically and use tax preparation software.
• Use the correct filing status.
• Answer the virtual currency question.
• Report all taxable income.
• Include unemployment compensation.
• Double-check name, birth date and Social Security number entries.
• Double-check routing and account numbers.
• Mail paper returns to the right address.
• Sign and date the return.

• **Failure to File a Premium Tax Credit Form**. Form 8962 is required for taxpayers who secure health insurance on the marketplace and pay their premiums using advance premium tax credits. For tax returns filed for the year 2021, the IRS will reject tax returns filed electronically without Form 8962. This policy will not apply to returns filed by paper.

Always be alert for fraudulent communications from IRS impersonators who are usually likely to reach out with threatening messages by email, fax or telephone.

• **Failure to Check the Virtual Currency Box.** As mentioned above, the IRS will this year reject returns that have failed to answer the question about virtual currency transactions during the tax year.

This list is not comprehensive and, certainly, where attachments are necessary and where accuracy is paramount, the failure to attach or be accurate will likely lead to either a rejection of the entire return, a request from the IRS for additional information or a request for additional tax payment based upon available information.

Preparing for an Audit

For anyone undergoing an audit, it is important to be responsive to the IRS letters and inquiries to guarantee having the opportunity to challenge any changes the IRS may want to make in tax liability. In addition, it is important to maintain detailed books and records, receipts and other proof of any income or deductions to substantiate a position taken on a tax return.

Process of Audit

The IRS may review three prior years in an audit, but can go back six years if it finds substantial errors. Communication with an agent will initially be by mail and may evolve into in-person meetings. However, always be alert for fraudulent communications from IRS impersonators who are usually likely to reach out with threatening messages by email, fax or telephone. But that's another story for another day.

Conclusion

Our tax system relies largely upon voluntary compliance bolstered by a sense of inherent fairness. The generally low audit percentage and erratic audit practices of the current system threaten that sense of fairness and the revenue it generates. A fear of audit influences 63% of taxpayers overall in reporting and paying taxes honestly, according to a Comprehensive Taxpayer Attitude Survey of the IRS published November 2020. As the number of audits decline, the corresponding amount of revenue from audits also declines. The IRS collected $28.2 billion from audits in 2010 but only $11.1 billion in 2019. A coherent, fair and equitable system of audit should be the goal of the future.

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