

WHAT ARE THE CHANCES OF BEING AUDITED BY THE IRS?



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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 are the chances of being audited?

NUMBER OF AUDITS IN THE US

The rate of audit has been in decline for at least a decade. In 2022, the audit rate for all taxpayers was 0.38 percent, down from 0.9 percent in 2009. To be more specific, for Fiscal Year 2022 the total number of audits was 626,204 out of 164,545,167 filed individual returns. This represents a slight decline from the previous year of a 0.4 percent audit rate. However, the audits that do occur do not equally impact all taxpayers. Notably, the audit rate of 1.27 percent for individuals below the poverty line in 2022 was just over three times the overall average and more than five times the rate of 0.023 percent for all taxpayers above the poverty line. Only 0.3 percent of all corporations were audited in 2018, down from 1.45 percent in 2010.

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. On the other hand, 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 percent, and field collection revenue officers, who manage difficult collections cases, dropped by 48 percent."¹ Testifying before the House Ways and Means Committee in March 2022, the Commissioner virtually waved a white flag of defeat in the face of corporate audits: "We do not have the resources to go after the bigs or the superbigs, as we refer to them, and we get outgunned routinely in that space."² This statement was followed by the May 6, 2022 report by the US Treasury Inspector General for Tax Administration (TIGTA) which also concluded that the decline in audits has been impacted by the reduction in audit examiners in all units: Large Business & International (LB&I) Division, Small Business and Self-Employed (SB/SE) Division, Tax Exempt and

Government Entities (TE/GE) Division, and Wage and Investment (W&I) Division.

In recent years, the IRS has relied on correspondence audits (i.e., those conducted solely by mail) as they require fewer IRS resources. In 2022 (as in 2021), 85 percent of all tax audits were correspondence audits and nearly 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 and can be performed in under five hours, without human intervention, and at a cost of just \$150.

Additional agents hired in recent years have not addressed the imbalance in audits. Most new hires have been tax examiners rather than revenue agents. 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 increased 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 determines which cases to audit, and the actual criteria for generating a DIF score remains an IRS secret. Behind this seemingly random method of selection is the process of comparing

certain “norms” or expectations to a random sample of returns.

NRP

In 2000, the IRS began the National Research Program (NRP) as a result of a directive from Congress requiring them, under the Reform & Restructuring Act of 1998, to conduct informational studies of taxpayer non-compliance to support tax policy and collection. The most recent highly visible NRP audits were conducted against former FBI director James B. Comey and former Deputy Director Andrew G. McCabe. This was a highly curious coincidence. The likelihood of an NRP audit is slim. Only 8,000 NRP audits were conducted in 2019 out of 154 million returns.

Taxpayer protection program and frivolous returns

IRS filters detect fraudulent and frivolous returns. A return that appears out of the ordinary compared with prior years may trigger investigation. A return taking a frivolous position can also trigger an audit. The IRS publishes an extensive list of frivolous positions, 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. For example, investors in tax shelters may wind up in an audit where the shelter itself is under review.

Income at the poverty level

Unfortunately, the odds of being audited increase five-fold 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. For those with adjusted gross income between \$1 and \$24,999, the audit rate

percentage has increased over the years, contrary to the general decline in audit rates. Fiscal Year 2022 showed a slight decline to 1.27 percent, down from 1.3 percent in 2021. The Congressional Research Service delved into the accusations of disproportionate auditing among lower income taxpayers and, in June 2022, issued a report (IN 11952) detailing their findings.³ Using 2017 statistics, they confirmed that one percent of all returns showing an EITC claim were audited and individual returns without EITC claims were audited at a lower rate of 0.3 percent.

High-income and high-net-worth non-filers

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 non-filers into compliance. Depending upon the situation, these cases may be referred to the Office of Fraud Enforcement within the SB/SE Division of the IRS or the IRS Criminal Investigation Division for Tax Evasion and Tax Fraud.

In Fiscal Year 2022, there were nearly 9.4 million taxpayers with positive income between \$200,000 and \$1 million. In 2022, 60,562 of these returns—or 0.64 percent—were audited, compared with 1.27 percent of returns audited by the IRS for lower-income taxpayers. Seventy-eight percent of those audits were simple correspondence audits. In the same year, those who had positive income of more than \$1 million were audited at the rate of 2.38 percent. Half of these millionaire audits were simple correspondence audits, reducing the likelihood of an agent audit to 1.1 percent. Statistics available from 2018 show that those earning more than \$10 million annually were audited at a higher rate of 5.3 percent.⁴

The IRS is hoping to have sufficient resources to audit higher income taxpayers with the additional funding it will receive from the Inflation Reduction Act. Treasury Secretary Janet Yellen recently wrote:

[E]nforcement resources will focus on high-end noncompliance ... by targeting crucial challenges, like large corporations, high-net-worth individuals and complex pass-throughs, where today the IRS has resources to initiate just 7,500 audits annually out of more than 4 million returns received.⁵

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 the “Dark Net” for child exploitation operations, international money laundering operations, virtual currency theft, and terrorism-financing sites maintained on behalf of al-Qaida, Hamas, and ISIS. A new question appears this year on the tax forms 1040, 1040-SR, and 1040-NR asking whether a taxpayer 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 rejected if e-filed or will result in a written request for correction if filed by mail.

Failure to file

The IRS Non-filer Inventory and Analysis Group is tasked with identifying non-filers by cross-checking third-party reporting information with a focus on individuals and businesses. In 2020, the IRS reported 2.7 individual non-filer cases and 71.7 business non-filers. Like audits in general, the number of non-filer notices are in decline. The IRS can track non-filers 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 US Attorney offices, from investigations by other law enforcement, from individual tips, and from tax treaties.

Claiming the EITC credit

The EITC is a refundable credit and 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 2023 will be \$7,430 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 percent of all EITC claims subject to exam.⁶ 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.”⁷ The Congressional Research Service offered this explanation: “In other words, a taxpayer in Mississippi is more likely to be audited than a taxpayer in New Hampshire, in part because they are more likely to be a taxpayer who claims the EITC.”⁸

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. In defense of increased auditing, the IRS Commissioner has noted that 50 percent 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 as many as 85 to 90 percent 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.⁹

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.”¹⁰

Claiming a refund

The IRS website asserts that “a refund is not necessarily a trigger for an audit.” Emphasis on the word “necessarily”!¹¹

Specific areas of interest to the IRS

Many new IRS compliance initiatives are issue-oriented, with “a focus on those issues that have been determined to present significant risk of noncompliance.”¹² There are currently 53 active issue-oriented campaigns within various divisions of the IRS. New campaigns are announced each year. For example, on February 7, 2022, the IRS LB&I Division added a new campaign focused on Partnership Losses in Excess of Partner's Basis Campaign.¹³

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. TIGTA issued a report in August 2021 specifically highlighting this problem and urged the IRS to do a better job of auditing these returns.¹⁴ According to the report and the IRS Data Book for 2020, fewer than one percent of all S corporations are selected for examination.¹⁵ Further, between 2016 and 2018, there were 266,095 returns filed by S corporations 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.¹⁶ 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 transactions.”¹⁷ Commissioner Rettig stated that 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.”¹⁸

Audit guidelines

The IRS publishes several Audit Technique Guides for revenue agents, which provide some indication of IRS interest in various taxpayers and issues, including attorneys, childcare 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.¹⁹ 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, and 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

Common reporting errors

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 misstate your filing status. Not everyone views this cross-checking as equivalent to 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 what is reported on the tax return.²⁰

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.”²¹ This is a fairly comprehensive list of misdeeds that stall the smooth processing of a tax 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.

Failure to check the virtual currency box

As mentioned above, the IRS will reject returns that have failed to answer the question about virtual currency transactions during the tax year. 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.

An audit may encompass a question about a single item or it may be more broad. Most audits are fully conducted, or at least initiated, by correspondence. Others may be conducted at the taxpayer's place of business and in person. The IRS may review three prior years in an audit but can go back six years if it finds substantial errors. Taxpayers should always be alert for fraudulent communications from IRS impersonators who are usually likely to reach out with threatening messages by e-mail, 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 rate and erratic audit practices of the current system threaten that sense of fairness and the revenue the tax system generates. A fear of audit influences 63 percent of taxpayers overall in reporting and paying taxes honestly, according to a Comprehensive Taxpayer Attitude Survey of the IRS published November 2020.²² 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.

The Inflation Reduction Act (2022) authorized an additional \$80 billion over 10 years for IRS funding which it is suggested will allow IRS to hire an

additional 87,000 new employees in taxpayer service positions. There has been much vocal concern about whether this will increase the number of audits and, if so, who will be impacted. I'm certain time will tell. We know that Treasury Secretary Janet Yellen has been quoted as saying that new funds "shall not be used to increase the share of small business or households below the \$400,000 threshold that are audited relative to historic levels."²³

Commissioner Rettig's letter to the House of Representatives from August 4, 2022 added:

These resources are absolutely not about increasing audit scrutiny on small businesses or middle-income Americans. As we've been planning, our investment of these enforcement resources is designed around the Department of the Treasury's directive that audit rates will not rise relative to recent years for households making under \$400,000 ... Enhanced IT systems and taxpayer service will actually mean that honest taxpayers will be better able to comply with the tax laws, resulting in a lower likelihood of being audited and a reduced burden on them.²⁴

The implementation of this goal was called into question by TIGTA in its January 12, 2023 report:

As of December 2022, IRS officials have not yet finalized what constituted the \$400,000 income level or what historic audit level will be used for its metrics. They indicated that this is still being discussed between the IRS and the Treasury Department. However, IRS officials do not believe there is an immediate risk of violating the Secretary's commitment because employee attrition and hiring challenges will limit its ability to conduct more audits.²⁵

For those who have attempted to negotiate with the IRS the past few years, either in audit or collection, it is well-known that the lack of staffing is causing lengthy delays in response times and so the prospect of additional agents might actually be a welcome improvement in service with minimal additional risk of audit. 🍀

Notes

- 1 Written Testimony of Charles P. Rettig, Commissioner, Internal Revenue Service, Before the House Ways and Means Committee, Subcommittee on Oversight on the Filing Season and COVID-19 Recovery (Mar. 18, 2021), available at <https://www.irs.gov/newsroom/written-testimony-of-charles-p-rettig-commissioner-internal-revenue-service-before-the-house-ways-and-means-committee-subcommittee-on-oversight-on-the-filing-season-and-covid-19-recovery>.
- 2 Michael Rainey, IRS Is 'Outgunned,' Commissioner Rettig Says, yahoo!finance (Mar. 17, 2022), available at https://finance.yahoo.com/news/irs-outgunned-commissioner-rettig-says-233156710.html?guccounter=1&guce_referrer=aHR0cHM6Ly93d3cuZ29vZ2x1LmNvbS8&guce_referrer_sig=AQAAAKqQbcLt8LlxZ-poZUHNrBlh6w3nb0tygS4hjUupEnWVLA4u7Blbqy8z4f-12bx6M4Au2M8UQ0dplEGP56hdPmLU8UzH3_WcE8B1E0E_zktFTT5I1hHQ46Y_9P9psGzL87yNWN63ud_kEjAz37rwhyXw7AhDaNK1dgQX4GHO5y6.
- 3 Cong. Rsch. Serv., Audits of EITC Returns: By the Numbers (June 13, 2022), available at <https://crsreports.congress.gov/product/pdf/IN/IN11952/1>.
- 4 New statistics for FY 2022 became available from Transactional Records Access Clearinghouse (TRAC) at Syracuse University as a result of Court Order under a Freedom of Information Act complaint. The future reporting of audit statistics in the IRS Data Book which is usually published in the spring of each year may omit this information in the future.
- 5 Letter from Janet Yellen, Sec. of the Treas., to Charles R. Rettig, Comm'r of the IRS (Aug. 10, 2022), available at <https://home.treasury.gov/system/files/136/JLY-letter-to-Commissioner-Rettig-Signed.pdf>.
- 6 The Earned Income Tax Credit Examination Compliance Strategy Can Be Improved, Rep. No. 2021-30-051, TIGTA, at 17 (Sept. 2, 2021), available at <https://www.tigta.gov/sites/default/files/reports/2022-02/202130051fr.pdf>.
- 7 Id. at 18.
- 8 Audits of EITC Returns: By the Numbers, *supra* note 3, at 3.
- 9 Guyton et al., The Effects of EITC Correspondence Audits on Low-Income Earners, Nat'l Bureau of Econ. Rsch., at 8 (Mar. 2018, revised Dec. 2019), available at https://www.nber.org/system/files/working_papers/w24465/w24465.pdf.
- 10 IRS Audits, Internal Revenue Serv. (Aug. 9, 2022), available at <https://www.irs.gov/businesses/small-businesses-self-employed/irs-audits>.
- 11 Id.
- 12 IRS adds a new compliance campaign (LB&I division), KPMG (Feb. 9, 2022), available at <https://home.kpmg/us/en/home/insights/2022/02/tnf-irs-list-compliance-campaigns.html>.
- 13 IRS Announces the Identification and Selection of One Large Business and International Compliance Campaign, Internal Revenue Serv. (Feb. 7, 2022), available at <https://www.irs.gov/businesses/small-businesses-self-employed/irs-lbi-compliance-campaigns-02072022>. For a full list of active campaigns, see <https://www.irs.gov/businesses/corporations/lbi-active-campaigns>.
- 14 Efforts to Address the Compliance Risk of Underreporting of S Corporation Officers' Compensation Are Increasing, but More Action Can Be Taken, Rep. No. 2021-30-042, TIGTA (Aug. 11, 2021), available at <https://www.tigta.gov/sites/default/files/reports/2022-02/202130042fr.pdf>.
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- 16 Id. at 6.
- 17 IR-News Rel. 2021-88, Apr. 19, 2021, available at <https://www.irs.gov/newsroom/20-year-exam-veteran-selected-as-new-office-of-promoter-investigations-acting-director>.
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- 20 NTA: Real Vs. Unreal Audits And Why This Distinction Matters, Nina Olson, Tax Connections (Jul. 10, 2018) available at <https://www.taxconnections.com/taxblog/nta-real-vs-unreal-audits-and-why-this-distinction-matters/>.
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- 22 Comprehensive Taxpayer Attitude Survey (CTAS) 2020, Publication 5296 (Rev. 4-2021), Research, Applied Analytics & Statistics (RAAS), Statistics of Income (SOI), Statistical Services Branch, Internal Revenue Serv., at 29 (Nov. 11, 2020).
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- 24 Letter from Charles P. Rettig, Commissioner, Internal Revenue Service, to members of the United States House of Representatives (Aug. 4, 2022), available at <https://www.irs.gov/pub/irs-utl/commissioners-letter-to-the-house.pdf>.
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