

## News & Views

# The IRS Audit from Hell

## Income Tax is Voluntary?

I know it does not seem like it but even though the Internal Revenue Code mandates we pay taxes; we do report our taxes under a “voluntary compliance” system.

Although our employers, banks and brokerage houses report most of our income to the IRS, we “voluntarily” report our other income and deductions. We figure our own tax refund or amount due and the IRS believes us, well most of the time.

For the most part we are on the honor system, and as taxpaying citizens we can only hope everyone does the right thing and pays their fair share.

## There is a Price to Pay for Everything

Every privilege has a cost. The cost of a voluntary compliance tax system is that every once in a while we need to check a few tax returns to make sure everyone is playing by the same rules.

Thence the IRS National Research Program Audit or as those of us who have been through one “The Audit from Hell.”

A National Research Project Audit (NRP) is something you do not wish upon your worst enemy.

In this audit, the IRS is not looking at one or two items to see if you reported them correctly and have the documents to prove it, they are ***looking at every single line item of your return and you must prove each item in detail.***

Every entry on the tax return must be proved by receipt or cancelled check. Personal returns are reviewed with the same intensity as business returns. This is a give no quarter, take no prisoners audit.

## Why?

Why does the IRS do these audits? In 2002, the IRS made an attempt to become “kinder and gentler” and did away with most line by line audits. They soon found they were not able to measure whether taxpayers and tax preparers were interpreting the tax rules accurately and reporting correctly. So in 2007 they reinstated the line by line audit.

Most taxpayers are chosen at random for the NRP audits. However, the IRS indicates it will use the data they procure from these audits to create “filters or profiles” to be used to select taxpayers for audits in the future.

## So, what to do?

The best way to survive a NRP audit or any audit is to plan to survive the audit in advance. A tax return is, in simple terms, a reconciliation of income and deductions.

First, remember that the internal revenue code presumes that “all income of whatever source derived” should be reported. Assuming you have reported all your income; the only items to defend are your deductions.

The tax code is very clear when it comes to deductions. When a plaintiff argues in tax court, that “something should be deductible,” the court refers to a phrase used in almost all US tax Court cases, “**a tax deduction is a matter of legislative grace.**” (*Interstate Transit Lines v. IRS*, 319 U.S. 590 at p. 593) (1943)

This means when it comes to federal income taxes, there are no deductions allowed unless Congress has specifically passed a law to allow for that deduction. And to be allowed to use the deduction you must meet the requirements of proper recordkeeping as defined by the US Congress.

That means organized and consistent recordkeeping. For example, if you drive your car for business or for charitable work or for going to medical appointments, keep a log. Record the mileage when you start, list where you went, and record the mileage when you finish the trip.

Keep all receipts for items reported on your tax return. Keep them with your tax return.

Make sure you get and keep receipts for charitable donations.

If you have a business, keep and organize all your receipts; especially fuel and qualifying meals and entertainment. Require drivers to keep mileage and maintenance logs. Keep your credit card statements, payroll records and state tax statements. Keep all billing statements and customer invoices. Keep your business bank statements and keep business activity separate from your personal banking.

**In a National Research Program Audit, anything you cannot prove you lose.** There are penalties for non compliance and poor recordkeeping. There are even more severe penalties if they charge fraud.

So, if you keep well organized records, keep up the good work. If you think you might need to improve your recordkeeping then you probably do and you need to get started.

A good place to start is the IRS website, [irs.gov](https://www.irs.gov). It has publications outlining required recordkeeping practices for business and personal tax returns.

## Finally

If you are selected for a NRP audit you should engage an Enrolled Agent or CPA to help guide you through the process. Give us a call and we can help you find an Enrolled agent in your area.