



What It's Like To Be Audited by IRS, Part Two

Last month's article was the first in a two-part series about an IRS audit, and this article finishes the story.

Last month's article ended with a dramatic moment—the Tax Compliance Officer is peering intently into a computer monitor at an image you can't see. You're wondering whether they have found something BAD.

Sometimes they have. They have access to the Social Security Administration's computer systems, and it is easy for them to trace 1099-MISC reporting.

If you own a business, and you engage independent contractors, you are obligated in most cases to send that person a 1099-MISC at the end of the year, and to send another copy to the government.

So in audit they check to see if the contractor who received the 1099 actually reported it. And when the contractor did not report the 1099 income, the auditor has an Aha! moment. Hence the intent gaze.

This issue didn't come up in this particular audit, but it's a good example of what goes on.

At this point, the auditor knows somebody is noncompliant with income reporting law. What s/he doesn't know is Who's the Bad Guy.

If you have honestly reported the 1099 income, and can document the payments with cancelled checks, then the Independent Contractor has just bought an audit for non-reporting income.

If, however, you cannot prove you paid the money, then the spotlight turns with full force on you. Have you fraudulently inflated expenses to avoid paying your full share of the tax?

At this point the auditor really doesn't know who is at fault here, but is pretty certain that someone has committed tax fraud.

And you've been thinking all along that the auditor is smart, knowledgeable, and probably a likable sort in another environment.

But all the time the auditor has been sizing you up, just as you you have been evaluating him or her. They're very alert, both to your personal mannerisms and responses,

as well as the paper trail you may have provided plus whatever is on that computer screen.

The audit can take different turns at this point, and with frightening speed. They may decide you're a compliant taxpayer, and all that happens is that you continue to have a pleasant conversation with someone you'd probably like to know under different circumstances.

Or the auditor may decide to probe a little bit. You still get a pleasant and respectful response, but you also get questions with sharp steel teeth in them.

Or the auditor may realize you truly have been noncompliant—you failed to report thousands of dollars of income. And in 5 seconds your pleasant friend is snarling at you: "So where did you put the money?"

I have only seen The Snarl one time. It was sufficient...

The Audit has a timing and a pace and a schedule of its own. They usually start with income sources, and once they are satisfied with income, they move to deductions and tax credits.

Deductions are a two-step process, really. First you must prove the cash—show a cancelled check, or receipt, or statement, or something that says you actually spent the money.

Having proved the cash, you must now prove the deductibility of that cash payment.

Here's where the paperwork and documentation comes in. Organized records are everything when the spotlight is turned on you.

In this case, our records were very well organized. The auditor would say, "Show me check number 8126 for \$325. And we would. Without fumbling.

Finding one check is a source of inexhaustible relief. But it's not enough. They'll pick another check, from another month, and keep on doing it til they are satisfied.

We spent the better part of a day getting ready for the audit, and slept well the night before. We were keyed up, of course, but not terribly threatened.

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We were glad to see an absence of armed guards, though.

Think about the process from the auditor's perspective. They do this every day, and they have routines and procedures to guide them and to fall back on. And they've got that computer monitor.

They can tell when someone's being evasive and possibly dishonest, just as you can tell in your line of work.

They see people every day, most of whom are scared but honest. And occasionally they see dishonest people who are trying to beat the system.

And they can tell the difference.

So what can you do if you get The Letter? Call them. Promptly. And keep good records.