

Understanding the Audit Process

If you receive a notice from the IRS, DON'T PANIC.

IRS audit flags are used by the IRS to help the IRS determine if a particular tax return should undergo an IRS audit. IRS audit flags are results of DIF score generation and DIF analysis.

IRS audit flags

IRS audit flags occur when tax returns are out of line with the national average. If a number on a particular tax return is out of line with others in similar income tax brackets, the DIF score identifies the return as having IRS audit potential.

For example, if the national average for charitable contributions for a certain income group is \$4,000 and a tax return contains \$13,000 in charitable contributions, the computer will flag this entry for a potential IRS audit.

IRS audit flags do not mean IRS audits

IRS audit flags do not always lead to IRS audits. IRS audit flags on a particular tax return does not mean the tax return is incorrect or an IRS audit is definite. After IRS audit flags, an IRS employee will manually review the tax return to determine if it has IRS audit potential. Not every tax return that is statistically out of line with the national averages will be audited.

Selecting tax returns for IRS audit

- DIF score
- IRS Matching Program
- Informant tips
- IRS Market segment specialization program
- Random audit

Tax Avoidance Schemes

- Tax Avoidance Schemes
- Business Tax Avoidance Schemes

How does the IRS Select tax returns for audit?

The IRS has many processes for selecting tax returns for IRS audit. There are several reasons why a tax return is selected for an IRS audit. Some of the reasons are outlined below:

- statistical analysis using DIF score system (DIF analysis)
- IRS matching programs
- IRS special projects on various occupations or professions
- informant tips
- evidence of criminal activity that produces probable unreported income (drugs, gambling, prostitution, etc.)
- random audits
- tax returns with prior IRS audits history

In the tax reform act 1998, Revenue Code IRC 7217 and made it a crime for most executive IRS branch members to interfere with an IRS audit. This was done to reassure tax payers that they couldn't be threatened with an audit due to personal conflicts.

How returns are selected for audit:

- DIF score
- IRS Matching Program
- IRS Audit Flags
- Informant tips
- IRS Market segment specialization program
- Random audit

What is a DIF score?

The DIF score is the most widely used method for selecting tax returns for IRS tax audit. There are also other methods to select tax returns for IRS audit. Since DIF score is used most often by the IRS raising IRS audit flags, we shall discuss how DIF score works to gain an understanding of the DIF score system.

What is a DIF score?

DIF score or "discriminate function" system is the name the IRS calls the computer generated score they use to select tax returns to undergo IRS audits. The majority of audited income tax returns are selected by means of DIF scores.

How is DIF score generated?

The DIF scores are generated by IRS computers. DIF score is a statistical profile that is computed by comparing the tax numbers (income, expenses, and deductions) on income tax returns with numbers generated using national statistics for tax payers in a similar income tax bracket.

Computing DIF score

The real formula of how to compute DIF score is not revealed by the IRS. However, contributing factors to computing DIF scores can be found on tax payers' tax returns.

An example of item on tax return used to compute DIF score is a loss on a sole proprietorship business (found on schedule C of the tax return). If these numbers or expenses are out of line with the numbers shown on DIF analysis, then the chances of an IRS audit increase. DIF score and DIF analysis is one of many factors the IRS uses to determine if an IRS audit is necessary.

Computerized matching program

IRS matching program is a computer program that the IRS developed. The IRS matching program is a process that selects many tax returns to perform IRS audits.

This program matches the information returns (W2, 1099) they receive from other sources to what is reported on your tax return. This is the most common reason you will receive an IRS notice, normally a CP- notice. **But don't be alarmed!** The most commonly found issues we have dealt with are either the IRS has input the forms in error, or the taxpayer failed to provide the form either because they didn't receive one, or they thought we didn't need it. Even though you include the income from a company that provides you with a 1099M in your total gross income, it still has to be reported as income from that 1099M.

After being selected through the matching program, The IRS reviews each tax return information it receives such as form w2, 1099, and 1098. The IRS then compares the tax return information on these tax returns to the tax return the tax payer have submitted, linking them via social security numbers. The IRS receives tax information from the following sources among many others:

- employers, wages (Form w2)
- gambling from casinos (Form w2G)
- pensions and annuities (Form 1099-R)
- over \$600 from services (Form 1099-MISC)
- banks interest (Form 1099-INT)
- mutual funds from stockbrokers (Form 1099-DIV, or 1099-B)
- state unemployment (Form 1099-G)
- state income tax refunds (Form 1099-G)
- real estate agents (Form 1099-S)
- corporations - dividends (Form 1099-DIV)
- mortgage interest (Form 1098)
- miscellaneous income (Form 1099-MISC)
- business (schedule K-1)

Matching program example

- Suppose that the IRS receives several forms w2 from a tax payer's social security number, which add up to \$30,000 in wages for the year. On a tax payer's tax return, the tax payer reports \$25,000 in wages. The IRS computer system will automatically adjust the tax payer's income by \$5000 and send the tax payer a bill for the additional tax due on this alleged unreported income.

- This may have been a mistake on the tax payer's part. Or, the tax payer may have reported the correct amount of wages and that one or more of the information on tax returns the IRS received was incorrect. Incorrect tax information could result from the employer listed the wrong social security number on one of the form w2, A tax payer should always check the accuracy of any IRS attempt to increase the amount of taxes due if the IRS sends a tax bill. Many instances that have occurred are from duplicate entry of W2s.

Informant tips

Believe it or not, yes the IRS will pay for a tip that results in the IRS recouping revenues!

- Informant tips also help the IRS determine which tax returns get IRS audits. Informant tips are information the IRS receives from various sources concerning questionable activities or tax information of a tax payer or tax payers.
- The IRS relies on information from informants to determine the IRS audit potential of a tax return. Many informants provide the information to the IRS anonymously. Sometimes informant tips come with rewards, monetary or otherwise.
- But if the informant wants to collect rewards or money for the information, the IRS informant must provide his or her identity to the IRS.
- Don't discuss any tax information with anyone, since you don't know who will turn out to be IRS informants and provide the IRS with informant tips, you should nevermore discuss confidential tax information with anyone. This includes friends and family members. Informant tips could be deciding factors for IRS audits of a tax payer's tax return.

IRS market segment specialization program (MSSP)

- IRS Market Segment Specialization Program (MSSP) is one of the IRS special projects conducted by the IRS regularly. The IRS Market Segment Specialization Program or MSSP was started in 1993 and is designed to examine and evaluate how businesses operate.
- The IRS routinely picks certain industries or professions and conducts IRS audits on a large percentage of tax returns that fit the IRS project criteria. The IRS calls this type of IRS audit the market segment specialization program (MSSP).
- The selection of tax returns are either based on the profession listed on the signature line or the business code used on the tax return Schedule c. Example of professions that are targets for IRS audit are Lawyers, nurses, ministers, construction workers, and mechanics.

Example of IRS market segment specialization program (MSSP)

- For example, the IRS has developed IRS audit strategies for targeting mobile food vendors such as people who sell hot dogs on street corners in US cities.
- Mostly cash business such as these are targeted mainly due to these types of vendors maintain poor records which makes them an easy IRS tax audit target for the IRS because they probably cannot afford to hire legal tax attorneys and cannot support their tax returns with complete documentation.

MSSP (IRS market segment specialization program) guide

- The MSSP (IRS market segment specialization program) guide goes on for several pages about how to attack the tax return and the tax payer personally.
- Other recent IRS projects have included doctors and dentists and their tax shelters and high expenses, sales person's high expenses especially travel and entertainment, airline pilots tax shelters and commuting expenses and ministers mail order ministry potential.

Random IRS audit

- Random IRS audit is a part of how the IRS selects tax returns to audit. In addition to using the DIF score system, the IRS matching program, and informant tips, the IRS also conducts a random IRS audit on various tax returns at random

Threat of the IRS random audit

- The IRS has always relied on the threat of conducting random IRS audits to encourage tax payers to voluntarily comply with the IRS tax laws. The IRS reasons that if a tax payer believes that his or her tax return will be selected for random audit, then the tax payer will be more likely to file correct tax returns.
- While there is no way to avoid a random IRS audit if a tax return is filed, the odds that an IRS audit will result from truly random selection are statistically very small. In another word, the chances of a random IRS audit are small.

National research program (NRP)

- The IRS also conducts IRS audits from its national research program (NRP) tax compliance audits. These National research program (NRP) IRS audits are much more intrusive than a regular IRS audit in that the IRS will be using these IRS audits to gather statistical information to update its computer system for DIF score purposes.

Now you understand the IRS right? Wrong, we will never understand the constantly changing system, but our hope is that understanding why you may or may not receive notices will help you in the future. And knowing the reasons these letters are sent will set you at ease if you ever receive one.

Hiring the right tax firm is important; having someone who understands these processes will also minimize your possibility of receiving a notice.

Always remember, that nothing is black and white, and the IRS does make many, many mistakes. We spend a great deal of time dealing with notices that are either incorrect due to IRS mis-keyed data or clients not receiving required forms from their employers or customers. Either way, please know we are here for you year round to help with anything that may arise.

Your friends at Impact Tax & Accounting Inc

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