

Five Ways to Audit-Proof Your Tax Returns

Every year, the Internal Revenue Service (IRS) issues thousands of audit notices to taxpayers who may have underpaid on their taxes. The consequences of being audited can be far-reaching, time-consuming and costly. This, coupled with the Biden administration's plans to increase funding to the IRS with the aim of expanding the number of tax examinations it performs, has many taxpayers worried about their filings this year.

It is therefore important that taxpayers take action now to protect their tax returns from scrutiny and ensure that their supporting documentation is adequate. Below, we address five regularly-audited tax areas and provide you with ways to audit-proof your tax return to ensure that you begin the new year feeling secure about how you'll approach your tax filings.

1. **Report all income that matches forms sent to the IRS.** Form W-2s and 1099s listing interest, dividend and other income are sent to both taxpayers and the IRS. These figures are entered into the IRS' matching computer programs and raise audit flags if such information is not included on the corresponding tax return. Be sure to follow up with your employer, bank, brokerage or pension fund for any such form that you do not receive, as these issuers are required to send you and the IRS copies.
2. **Claim deductions for business expenses.** For expenses to be deductible they must be both ordinary and necessary within the business' trade or activities. However, the IRS categorizes business tax returns using a variety of codes to develop averages for deductions of similarly situated companies. Those with outlier expenses and too many deductions or uncommonly claimed deductions are ripe for further examination. Make sure to properly document your business expenses to show how they relate to your business operations and be ready to provide a narrative if there are many sizable expenses in comparison to your level of income.
3. **Properly disclose international assets.** Just because assets are held offshore does not mean they aren't subject to U.S. tax and disclosure requirements. Failure to report international income can lead to extremely high penalties, often up to \$10,000 per form filing. Unlike U.S.-based investments, foreign investments often do not issue formal tax

documents, therefore you need to contact the foreign corporation, bank or brokerage to obtain the necessary information to file an accurate tax return.

4. **Report cryptocurrency transactions.** Similar to traditional transactions, cryptocurrency transactions need to be disclosed on your tax returns even though they are not always reported on traditional brokerage documents. Increased government oversight into crypto exchanges and transactions has created further scrutiny in this area. Although intangible in form, cryptocurrencies are treated as property under IRS guidelines and any gains or losses from trading must be reported. Further, without bank records taxpayers must retain purchase and sale records to support the valuations reported on their tax returns.
5. **Pay attention to treatment of real estate losses.** Passive investors in real estate properties are generally not able to deduct passive losses on their income tax returns until the property generates positive cash flow or is sold. This is often the situation for new real estate investments where losses are generated in the early years due to substantial depreciation expenses, yet the losses are not deductible and are carried forward to future tax years. However, certain taxpayers can claim these losses if they qualify as real estate professionals. Tax law requires that more than half of the services provided by real estate professionals relate to real estate in that the individual materially participates in them and spends more than 750 hours per year servicing real property. Many audits focus on the distinction between a passive investor and a real estate professional with a critical review of the records relating to the time actually spent performing real estate services.