IRS Audit Targets

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Imagine playing in a competitive game where you know your opponent's basic strategies and operating procedures. That's a nice advantage, and one that taxpayers have with the Internal Revenue Service ("IRS"). Knowledge about IRS audit targets is actually pretty easy to come by, since the IRS announces them in a series of public communications. As far as IRS procedures, the IRS publishes them in exhaustive detail in the Internal Revenue Manual. This knowledge means you can lessen your chance of audit by following some fairly simple steps.

"I Have Nothing To Hide." Even if you believe you have no audit exposure, an audit can cost a great deal of professional time to successfully resolve. Professional time = fees and costs. I've also experienced many instances of agents proposing adjustments that made no sense. They were ultimately overturned, but that means time and money.

How Are Returns Selected For Audit? As returns are processed by IRS computers, at least two steps occur. First, the IRS matches information reported by third parties (such as mortgage interest paid and dividends received) to the tax return. In most cases, if there is a discrepancy, an automated inquiry will be sent to the taxpayer to explain it. Second, the computer assigns a "score" to the return, based on the probability of audit adjustments. The higher the score, the more revenue the IRS believes may be generated by an audit, increasing the odds of an audit.

The "scores" are based on algorithms that compare the levels of reported income, deductions, and similar relationships. Although the algorithms are secret, common sense dictates that if you have little income, but very large charitable deductions, that unusual relationship will result in a higher score. The key point here is that returns with a high score are manually reviewed before the return is actually assigned for an audit.

What Are Other Ways Returns Are Selected For Audit? The IRS publishes an Annual Audit Plan describing their audit priorities. For example, the 2020 Annual Audit Plan focuses on returns with Schedule C, the matching of currency transaction reports to returns, targeting high-income and high-wealth taxpayers who don't file returns, reasonable compensation audits of closely held S corporations and their shareholders (this is to catch shareholders who pay small salaries yet take large distributions to minimize self-employment taxes), and targeting high-income taxpayers in general.

Announcements. The IRS Large Business and International Division ("LB&I") announced that it will increase its focus on "certain" high-income taxpayers (notice a trend here?), especially those with pass-through entities. Historically, partnerships have experienced very low audit rates, primarily because the partnership itself pays no tax. However, the new partnership audit rules, which can

let the IRS collect taxes directly from the partnership instead of its individual partners, and the focus on wealthy partnership owners, mean that the partnership audit rate will probably increase.

This does not mean you should avoid using partnerships. Sometimes taxpayers forego a partnership in favor of treating an entity such as an LLC as a "disregarded entity." The problem with that approach is that the individual owner's return becomes much more complicated. For example, if the LLC owns investment property, all of the items that would be reported on a separate partnership return and flow through as a single line item on the individual return are instead reported in detail on schedule E, causing a higher audit risk for the individual return.

Specialized Programs. The IRS isn't shy about announcing their targeting of certain disfavored transactions. These include initiatives targeting micro-captive insurance companies, syndicated conservation easements, and a new program targeting private foundations.

It will be interesting to see how the above IRS audit priorities will play out in practice. Audit rates in general have been declining substantially over the years, and higher income taxpayers have always experienced higher audit rates. The IRS is putting greater emphasis on computer and data analysis, and given what's happened with the huge budget deficits following the Fed's response to the COVID crisis, we can expect more Congressional pressure on the IRS to "protect the revenue."

Conclusions. If you have unusual items on your return, attaching a detailed statement explaining i) what happened, ii) the basis for the treatment reflected on the return for the item, and iii) who the IRS can contact for additional information may prevent an audit. It won't stop the return from getting a high score, but when the return is manually reviewed to verify its audit potential, adding the statement may avoid assignment of the return for an actual audit.

This advice is especially pertinent for large refund claims, another IRS audit priority. If you are claiming a substantial refund, your return should include as much information (facts, citations of authority, even pertinent documents) as possible. Ultimately a human being will look at this information. The message including this information sends is "nothing to see here."

If you have participated in a targeted transaction, such as a micro-captive insurance company or conservation easement, just because the IRS has targeted the transaction doesn't mean it isn't valid. The reason the IRS targets such transactions is that they have been abused by certain parties, but that doesn't mean your transaction won't pass scrutiny. However, you should have competent advisors respond thoroughly and proactively to the first IRS communication you receive. Remember, "nothing to see here."

Do you have questions about how this article may apply to you or your clients? Feel free to contact me at
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