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5 Red Flags the IRS Looks for in your Tax Returns (part 1)

In their bid to close the ‘tax gap’, the difference between the amount of taxes that are due and actual taxes collected, the IRS continuously scrutinizes your tax returns for evidence of under-payment or non-payment of legitimate taxes. According to the IRS, the tax gap amounts to some $350 billion each year. To recoup as much of this as possible, the IRS is specifically targeting taxpayers with high incomes, fat bank accounts, large investments and complicated taxes.

The IRS has beefed up its operations on collecting taxes from the wealthy by setting up the Global High Wealth Industry (GHWI) unit last year, staffed with its most aggressive and competent auditors. For those of you who earn more than $1 million a year, 8.4% of you will be audited. And if you earned for than $10 million, the percentage of you who will be audited is 18.4%, up from 10.6% last year. With the setting up of the GHWI unit, the audit rate for the rich is bound to increase.

In the past, the audit process involved one auditor looking through your 1040. But with the wealthy who have lots of assets and possibly various businesses with diverse sources of income, just one auditor is unlikely to suffice. However, with the GHWI, there will be a team of auditors each with expertise in a number of areas who will scrutinize your 1040.

But what do they look for? Here are 5 potential red flags that would catch the attention of the IRS.

1. Property Transfers

If transferring property to anyone, you must file a gift-tax return for any gift valued at more than the annual $13,000 gift-tax exclusion. Transferring property to heirs is becoming more popular these days with the depressed prices of property meaning the givers will not pay as much in taxes and heirs would stand to gain when the properties appreciate in price in future.

The IRS realizes this trend so they have been counterchecking property transfer records in various states with gift-tax returns. But if you have made a property transfer, it does not mean you are taxable. You can avoid the 35% gift tax by tapping the one-time estate-tax exemption, which is much higher. The gift tax exemption was a total of $1 million for last year. This means if you gave a property to someone valued at over $1 million last year, you would have to pay taxes on it.

For this year and next year, the estate-tax exemption for gift giving is $5 million for individuals or $10 million for couples. Once the exemption is used up, you can give as much as $13,000 to as many individuals as you like each year ($26,000 for a couple) without being taxed.

2. Selected Investment Losses

Suppose you are a minority owner or ‘sleeping partner’ in a company that made a loss last year but you have your own Subchapter S cooperation or partnership where you derive your main income. You might think you can declare this loss and offset your income or profit in your Subchapter S corporation or partnership.

This is not allowed unless you are an active stakeholder involved in the actual running of your loss-making company. You can only use the loss to offset any other passive income you have, but not your main business income.

Let’s continue this discussion in part 2 tomorrow.