

Tips to Audit Proof Your Records A Guide for Individuals

The IRS will audit hundreds of thousands of individual tax returns this year. Although that represents but a small percentage of all returns filed, this is of little consolation if your return is among those selected for audit. But with proper preparation and planning, you should fare well.

The purpose of the audit is to verify items reported on a tax return. The easiest way to survive a tax audit is to prepare for one in advance. On an ongoing basis you should systematically maintain documentation—invoices, bills, cancelled checks, receipts or other proof—for all items to be reported on your tax return. Here are some tips to make the job easier and to help ensure you can come up with the records needed if you get audited.

Checking Accounts

If you operate a business or have rental properties, we strongly recommend you keep separate checking accounts for:

- You and your spouse,
- Each business you operate as a sole proprietorship,
- Each corporation you own, and
- Rental properties

Separate accounts make tracking your deductions easier since all expenses are in one place. You won't have to go searching personal accounts for expenses if you keep the records separate. And for your business, it is one additional piece of evidence that makes your business appear to operate as a for-profit activity if the IRS challenges a business with losses as a non-deductible hobby.

All Business Income gets Deposited into Your Business Account

Do not commingle business income with your personal accounts. In other words never deposit income from your customers straight into your personal accounts. Never pay business expenses from your personal account. The IRS does not like commingling of personal and business activities. They will consider all deposits into all accounts as income, unless you can prove otherwise. So keeping the records straight and not confusing the auditor will simplify the audit and simplify your need to respond to IRS requests.

By the way, if you get loans from family members for your business this is not income; but you need to prove it! Keep documentation of the loan such as a copy of the check, and prepare a loan agreement between you and the family member so you can prove this was not income.

Keep Copies of Checks and Bank Statements for Proof of Deductions

If your bank already does not do this, ask them to provide scanned images of your cancelled checks. The banks did a huge disservice to business owners and individuals when they stopped providing cancelled checks or images of cancelled checks. Many banks will do this for free or a nominal charge, but many times you need to request this. Don't rely on cancelled checks being available online 3, 4 or 5 years down the road. Some banks keep them for only 90 days. And

what happens if you switch banks and close the old accounts? Your banking history may be gone forever.

You Must Prove TWO Things in an Audit

For every single deduction on your return, you have prove to these **two things**:

1. You need to prove what you bought,
2. You need to prove you paid for what you bought.

Let me emphasize the word BOTH. There is a misconception that just a receipt or just a credit card statement is enough. It's not true! Without both pieces of documentation, the IRS will disallow the deduction on your return.

Step 1: What you bought - Generally, the receipt or invoice will prove both the description of what you bought and how this purchase relates to your business (or rental property, unreimbursed employee expenses, etc). With entertainment at a restaurant, the receipt proves what you had to eat and drink. Get an itemized invoice for every purchase.

Step 2: That you paid - Tax law considers the charge to a credit card as payment, regardless of when the card gets paid. Thus, you can prove payment by credit card with either the credit card receipt that shows the total charge or the credit card statement. Of course if you paid by check you will need a copy of the cancelled check (a carbon copy, or regular copy of a check does not work).

As a general rule, don't pay in cash. These are the first questions an auditor will ask about a cash payment:

- Where did the cash come from?
- How good is the trail of cash to the payment?
- Was an ATM withdrawal evident before the cash payment?
- Did the taxpayer really spend the cash or just make up this deduction?

You face no such questions for payments by check or credit card.

Organize Your Files

The government normally has three years or more within which to conduct an audit, and often the audit won't begin until a year or more after you file your return. So don't trust your memory. Leave a good trail. If you have to go back to your records later, you should be able to backtrack all of the entries on your return.

The scope of an audit depends on the complexity of the return being examined. A return reflecting business or real estate income and expenses is likely to take longer to audit than a return reflecting only salary income. You can facilitate matters by having the necessary records arranged in an orderly and systematic fashion for presentation to the IRS agent. The typical IRS agent is experienced and knows his job. Trying to outsmart the agent or sidestepping questions, intentionally or not, is likely to create friction and raise suspicions in the agent's mind.

For each of your deductible expenses, attach a copy of the payment (cancelled check, credit card receipt or credit card statement) to the invoice. Do this when you incur the expense, on a weekly or monthly basis. File the invoice in a year-end tax folder by deduction type (e.g. rental property, unreimbursed employee expense, charitable, etc.). If you own a business file it by vendor name and record the purchase in your bookkeeping software. This way you have both pieces of documentation for every deduction you claim.

If you have many deductions in a year, use software such as Quicken for your personal finances or QuickBooks if you have a business. If you have a business, QuickBooks is a must.

Keep Your Records on a Daily Basis

We heard you screaming when you saw the word “daily” above. Don’t worry, the daily requirement, which actually existed for auto expenses in 1984, was repealed and replaced with an adequate records requirement. So the IRS now gives you a week to meet the “timely” and “adequate” records requirements for vehicles, travel, entertainment, and listed property. Don’t wait until tax time or, even worse, three years later when you get the audit notice.

We doubt that you will, but you probably should thank the IRS for the one-week rule. Why? Because recording your business expenses within one week makes good business sense. After all, if you wait too long, you won’t remember the nature or reason for the expenses.

Keep Logs

To deduct your vehicle expenses, whether it is for business, charitable use, for your rental properties, or any other deduction on your return, you need proof of use. This is true whether you take the standard mileage deduction or deduct actual vehicle expenses. If you have deductions for a business, this is true regardless of the form your business takes. Thus, if you operate as a corporation, you (the employee) must submit proof of your business use to the corporation.

This mileage log should be kept on a regular basis (daily, weekly) and must include the date of travel, mileage for the trip (IRS likes to see beginning and ending odometer readings), and business purpose of the trip. If you are claiming actual expenses instead of claiming using the standard mileage rate, you will need receipts for all expenses of the car including gas, maintenance insurance, etc., in addition to the mileage log.

We recommend that you keep your vehicle mileage in your appointment book so it reflects your business activities for each day. Further, the appointment-book recordings facilitate use of a sampling method, such as the three-month log of business miles to prove business use for the year.

If you own rental properties, you should track for at least three consecutive months the time spent on the rentals, to prove material participation and, if applicable, real estate professional status.

If you claim a deduction for an office in the home, you should track time spent working in the home office. Your use of the home office must meet the “regular use” test. If you use your home office a little more than 10 hours a week on a consistent basis, you meet the requirements for regular use.

Keep all your records in one place and hold on to your calculations.

Statute of Limitations

The “statute of limitations” refers to the period of time when you and the IRS can make changes to your tax returns. Most taxpayers think of the limitation periods as the time frames during which the IRS can audit returns. The periods laid out in IRS publications are listed below:

- Three years, if you filed on time or with extensions and did not understate your income by 25 percent or more, and did not file a fraudulent return
- Six years, if you filed on time or with extensions but understated your income by more than 25 percent
- Forever, no limit, if you filed a fraudulent return
- Forever, no limit, if you did not file a return
- Three years after filing or two years after the tax was paid, if you filed an amended return or other change to your original return, such as a quick claim for refund
- Seven years, if you filed a claim for a loss from worthless securities or a bad-debt deduction

How Long to Keep Records

The statutes of limitations tell you the time period during which the IRS can audit your returns. If your returns are examined, you need tax records that prove your deductions. This means you need to keep your records for longer than you might think.

Assets. Assets such as your car, desk, computer, and office building are relevant to your tax return during their depreciable class lives.

- If you are depreciating the assets, the depreciation shows up in those returns.
- If you used Section 179 to expense the assets, then you have potential recapture during the depreciable class life.

Example. You buy a \$1,500 desk and depreciate it over the seven-year MACRS life (this takes eight years). In year eight, you still have to prove the depreciation. That means you need the original purchase record in year eight. You also need the purchase record in year eleven to meet the three-year statute of limitations on this year eight deduction.

If you used Section 179 expensing on this desk, your records requirement is identical to the example. You have recapture exposure during the eight years, and you need to hold onto your proof of purchase for three years beyond that, or 11 years in total.

Make this easy. For any asset that has a life of more than one year, keep the purchase records in a permanent file. With a separate permanent file of asset purchases, you don't have to think or worry about class lives or limitation periods.

The five-drawer method. To use the five-drawer method, you need to keep your permanent files in another place (such as a different set of file drawers). Next, you must report your income and file and pay your taxes on time or with extensions, to limit your audit exposure to three years from the date you filed your return. If you fit this profile, the five-drawer system can simplify your records retention. It works like this:

- Drawer 1: Accumulation of current year tax return information
- Drawer 2: Last year (tax return filed this year, say on April 15)
- Drawer 3: Two years ago
- Drawer 4: Three years ago
- Drawer 5: Four years ago

At the beginning of each year, the contents of drawer 5 go to the dump and all drawers move down one notch.

Representation. Even if you prepared your own return, it is often advisable to have a tax professional represent you at an audit. Your representative knows what issues the IRS agent is likely to focus on and can prepare accordingly. More importantly, a tax professional knows that in many instances IRS agents will take a position (for example, to disallow deduction of a certain type of expense) even though courts and other authority have expressed a contrary opinion on the issue. Because the representative knows and can point to the proper authority, the IRS agent may be forced to throw in the towel.

These are general guidelines but should be considered to be minimum requirements. If you have any specific questions, please contact our office.