Tax Time: Five Red Flags That Raise the Odds of an Audit

The IRS audited about 1 million tax returns in fiscal year 2018, and nearly 75% of those examinations were conducted entirely through correspondence.[1] Taxpayers selected for an official audit are notified by mail. Confusing matters, the IRS also mails other types of compliance notices, which may propose additional tax based on math errors, the automated detection of underreported income, or other factors.

The National Taxpayer Advocate calls these notices "unreal" audits, because the IRS doesn't count them as audits. But their impact is real — so the frequency and effectiveness of IRS compliance contacts is somewhat understated. About 8.5 million taxpayers experienced "unreal" audits during fiscal year 2016, and if they were included the audit rate would jump from 0.7% to more than 6.0%.[2]

FY 2018 audit rates for individual tax returns, by adjusted gross income

No AGI	2.04%
Under $25,000	0.69%
$25,000–$49,999	0.48%
$50,000–$74,999	0.54%
$75,000–$99,999	0.45%
$100,000–$199,999	0.44%
$200,000–$499,999	0.53%
$500,000–$999,999	1.10%
$1,000,000–$4,999,999	2.21%
$5,000,000–$9,999,999	4.21%
$10,000,000 or more	6.66%

Source: Internal Revenue Service, 2019

When the IRS Gets Real

If selected for a correspondence audit, you may be asked to mail specific information to the IRS. Some examinations require an in-person interview, which could take place in an IRS office (referred to as an office audit). A comprehensive field audit would be conducted at your home, place of business, or accountant's office.

How is a return selected for examination? When your federal income tax return is processed, a computer program called the Discriminant Inventory Function System (DIF) screens for anomalies, compares deductions to those of taxpayers with similar incomes, and assigns a DIF score. The higher the DIF score, the greater the potential that an audit will result in the collection of additional taxes. In some cases, a return is examined because it's related to a transaction with another taxpayer who has been audited.

Risky Returns

There's no way to know exactly what will trigger an audit, but one or more of the following red flags could make it more likely that the IRS will take a closer look at your tax return.

1. Missing income. Don't forget sources of income not reported on a Form W-2, which might include investment income, interest, royalties, rent, compensation as an independent contractor, forgiven debt, alimony, tips, gambling winnings, health insurance reimbursements for expenses deducted in a previous year, and proceeds from selling goods online. These types of income may or may not be reported by the payer to the IRS, but you must include all income, whether you receive a Form 1099 or not.

2. Overdoing deductions. Even if they are allowed by law, deductions that are unusually large for your income level can appear suspicious. For this reason, high-value charitable donations require specific documentation.

3. Filing a Schedule C. Thorough recordkeeping is critical for self-employed taxpayers, especially when claiming deductions for a home office or vehicle expenses (which require a written log).

4. Keeping money in foreign accounts. Foreign assets worth at least $50,000 at year-end or greater than $75,000 at any time during the year must be reported. (These thresholds are $100,000 and $150,000, respectively, for married joint filers.) Other complicated rules apply. Many overseas financial institutions are required to provide information about U.S. asset holders to the IRS, so even though the reporting of foreign assets (by you or the institution) may invite IRS scrutiny, noncompliance can result in penalties or legal problems.

5. Reporting a high (or very low) income. Audit rates are higher for wealthier taxpayers as well as for those with little or no income (possibly due to questionable tax deductions).

Even though these situations are more complicated, they are often perfectly valid. Still, it might be wise to consult a trusted tax or legal professional if you receive any type of compliance-related communication from the IRS.

1) Internal Revenue Service, 2019
2) Taxpayer Advocate Service, 2018

Back To Top