2023 Tax Return Audit Avoidance Tips

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Tax Avoidance is generally deemed a more acceptable term in polite conversation than Tax Evasion, but AUDIT Avoidance is always proper and appropriate for discussion in any social setting. As we prepare for our annual exercise culminating with filing on Monday, April 15, 2024, let us review some tips and traps on the Audit Avoidance journey.

Report All Income

Income comes from various sources, but all of them report to you on forms that they share with the IRS:

- Wages (W-2)
- Social Security (SSA-1099)
- Pensions, IRA/401(k) distributions or annuities (1099-R)
- Gig or independent contractor income (1099-NEC)
- Partnership income (K-1)
- Rent or royalties (1099-MISC)
- Real estate sale proceeds (1099-S)
- Income from Interest (1099-INT), Dividends (1099-DIV) or capital gains (1099-B)

Any difference between what you report on your Form 1040 and what the IRS gets on 1099s is **AUDIT RED FLAG #1**. The first partner I worked with as a fledgling tax law practitioner repeatedly advised me: "Declare every nickel of income but be sure to claim every nickel of deduction/credit to avoid an audit or to generate a good result if one occurs."

Watch Out for Business Losses

- New businesses lose money for a period of start-up time, but if you lose money year after year, you risk the IRS classifying it as a hobby, rather than a business. Take your legitimate losses, but do not overreach.
- Acceptable documentation is required to prove income and expenses, particularly if you are a cash-based business. Save records for seven years.
- This is **AUDIT RED FLAG #2**.

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Claim Your Deductions/Credits

- Changes from the 2017 Tax Cuts and Jobs Act ("TCJA") sunset after December 31, 2025, and tax rates and terms return to 2017 levels, adjusted for inflation.
    - TCJA reduced deductions and raised standard deduction levels, causing fewer taxpayers to itemize on their Form 1040s.
    - Most of those reading this will likely itemize, however.

Charitable Deductions

- Watch out if your level of charitable giving is outside of what is "normal [?]" for your level of income. **AUDIT RED FLAG #3.**
- Careful recordkeeping is the key to success.
- Deductions for donations to public charities (including donor-advised funds) is
    - Generally limited to 50% of Adjusted Gross Income ("AGI").
    - Limit increases to 60% of AGI for cash gifts.
    - Donating appreciated non-cash assets held for over one year is limited to 30% of AGI.

Home Office Deduction [a perennial favorite]

- Must be self-employed and conduct most of your business from home—if you receive a W-2 from your employer, who allows you to work from home, you do not qualify. **AUDIT RED FLAG #4.**
- Common methods of calculating the home office deduction:
    - Simplified Method—multiply a prescribed rate [$5.00] by the square footage of space in your home that is used for business purposes [maximum of three hundred square feet]... Little paperwork required.
    - Regular Method—the actual expenses method. You must maintain records as to the expenses of your home office {mortgage interest, insurance, utilities, repairs, and depreciation]. Allocate these expenses based on the percentage of your home devoted to business use.

Business Owner with Wildly Fluctuating Income

- Puts an unwanted spotlight on your tax return, raising suspicions that you may be underreporting income. **AUDIT RED FLAG #5.**
- Most tax software programs allow you to include a note and documentation explaining the unique circumstances.

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Avoid Abusive Tax Shelters

- IRS flagged abusive transactions include syndicated conservation easements, micro-captive insurance company structures and Malta retirement plans (Bloomberg Tax). Also, scams involving the earned income tax credit, sick leave, family leave and false fuel credit claims. **AUDIT RED FLAG #6.**

Tax Audits

- You cannot bullet-proof your tax return completely, and the higher your income, the higher their scrutiny.
- If you receive the dreaded letter from the IRS, it will most commonly be a letter detailing the money the IRS believes you owe, along with penalty and interest (of course).
- You will have a specified time to prove to the IRS that your original filing is correct, using your carefully retained records discussed earlier.
- In the face of this convincing documentation, the IRS should agree with you, and all is fine.

Capital Gains versus Ordinary Income

I close by reviewing an area that is not an audit flag but is one of the least understood income tax concepts applying to most taxpayers—the interaction between taxation of ordinary income and capital gains.

- Capital gains are recognized when you sell an investment for more than you paid for it in a non-retirement taxable account.
- Capital gains are stacked on top of ordinary income to calculate taxable income.
- The capital gains tax rate can go up or down depending on your ordinary income, but your capital gains are always taxed at their own capital gains tax rate—not ordinary income tax rates.
- Capital gains enjoy a 0% tax rate until a married filing joint ("MFJ") couple have a taxable income of $94,050.
  - When added to the $29,200 MFJ standard deduction for 2024, if you had no income, you could have $123,250 of long-term (held over one year) capital gains and pay nothing in taxes. Capital gains get stacked on top of ordinary income but are then taxed at their own rates.
  - If you had $40,000 of ordinary income, you could have $83,250 of long-term capital gains and still pay 0% capital gains tax. You would pay income tax on $40,000 - $29,200 standard deduction = $10,800 * 10% = $1,080 income tax.
  - If you had $94,050 in ordinary income and $15,000 of long-term capital gains you would pay $15,000 * 15% = $2,250 in capital gains tax.

- So, when doing tax margin management, remember that if you have lower income and can fill up the 0% capital gains tax bracket, consider recognizing additional income if it results in paying $0 taxes. Run tax projections to confirm.
- Also remember that capital gains and ordinary income increase AGI for purposes of Medicare payments and other income-driven expenses.

Always remember to pay the taxes you rightfully owe but feel no compulsion to leave the IRS a tip. We are always available to assist you with any tax questions at wealth@firstcarolinabank.com.