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Mind the Gap

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Some taxpayers underreport income, overstate deductions, or both to reduce their tax bills. Such behavior gives rise to the "tax gap," taxes owed but never paid to the U.S. Department of the Treasury. Estimates of the tax gap average roughly $400 billion. Nearly 85 percent ($340 billion) of that is attributed to underreporting of income, three-quarters ($255 billion) of which is associated with individual taxpayers.

While new and intensified audit techniques are mainly focusing on cash businesses (such as coin laundries, beauty salons, and coin-operated businesses), some will undoubtedly affect noncash business audits as well. Some real estate owners and businesses are certain to be on the IRS radar.

On average, the IRS spent 41 cents to collect $100 in tax revenue during its 2015–16 fiscal year, matching the low-cost results for previous years. However, over the last six years, the IRS was forced to cut its workforce to 82,000 from nearly 94,000, a 13 percent decline. This reduced the number of returns that could be examined (see figure) and put more pressure on the remaining agents to make up the difference via audits.

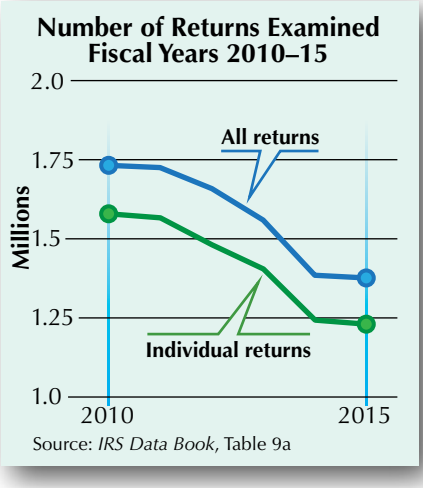
The Takeaway

Due to the continuous rise in underreported taxable income, the IRS has intensified its previous audit techniques and created new ones. These steps may adversely affect homeowners and real estate businesses.

For example, IRS auditors are examining the assets and liabilities listed on homebuyer mortgage applications and comparing them with the level of income reported on tax returns. Anecdotal evidence suggests that some homebuyers inflate the asset values listed on mortgage applications to convey a higher level of financial strength hoping to increase the likelihood of obtaining a loan or more preferable loan terms. The problem is that erroneous mortgage applications are fraudulent, and the IRS may turn the evidence over to other law enforcement agencies for prosecution.

Why is the IRS interested in assets *per se?* The interest in assets stems from an intensified audit technique known as "net worth" auditing. Assets and income are

linked because of the relationship between accumulated wealth and the income stream that produced it. Of course, loans, inheritances, and gifts may explain high wealth accumulation, and those sources are completely legitimate.



As noted, large discrepancies between income and wealth can trigger an audit. Understating income is fraud and can result in fines and possibly criminal penalties, including jail sentences. Some celebrities with such tax troubles include Willie Nelson, who paid $15 million in back taxes after the IRS seized nearly all of his assets. Wesley Snipes spent over two years in jail and paid $7 million in back taxes. Baseball player Pete Rose spent five months in jail and paid over $1 million in fines and penalties due to unreported income.

As expected, the IRS also scrutinizes expenses. A new approach is to compare deductions with industry averages. Thus, in the real estate area, comparisons may be made in the areas of expense margins, meals and entertainment, mileage, advertising, profitability over time, real estate taxes, and cash transactions of any kind. The auditing agent may also look at the size of a mortgage compared with the approximate value of the home.

Taxpayers being audited should respond promptly to all audit requests but *should not* provide information not specifically requested by the IRS, and *should not* discuss details of the audit on social media. Under the new audit procedures, the IRS routinely reviews social media as part of its investigations.

Perhaps the most important action a taxpayer can take is to hire a tax accountant or tax attorney knowledgeable in real estate matters, especially one experienced in representing clients for IRS audit purposes.

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