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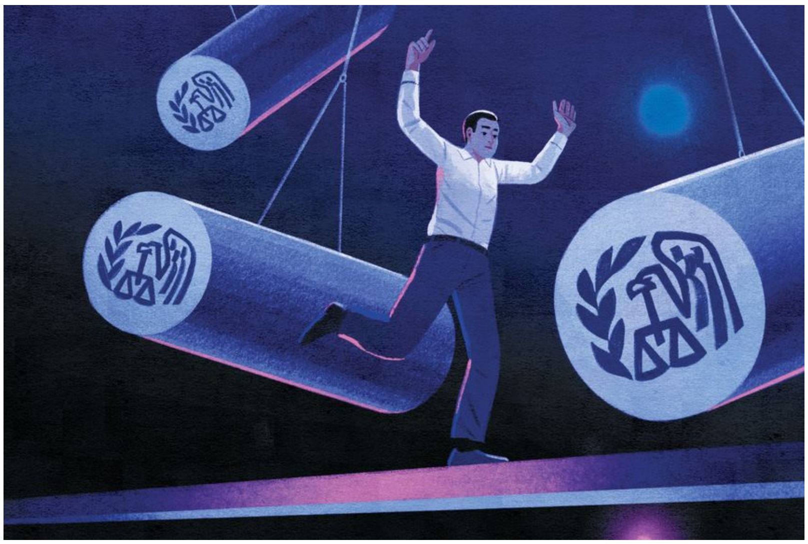
JOURNAL REPORTS: PERSONAL INVESTING

10 Red Flags That Could Trigger an IRS Tax Audit in 2022

Accounting for pandemic-inspired grants, loans and tax credits could make it a tricky year for many



Fewer than one million Americans get audited annually—but those who don't file, or underreport their income, are top of the list.

ILLUSTRATION: RYAN JOHNSON

By Lori Ioannou

Updated March 5, 2022 12:09 am ET

For most Americans, any letter from the Internal Revenue Service sparks fear, especially a notice of a tax audit.

Unfortunately, a confluence of factors—including the pandemic-inspired federal grant, loan and tax-credit programs—will make this a particularly complex tax-filing season for individuals and business owners.

"Filing your taxes could be a minefield this year because of all the tax-law changes, credits and programs that rolled out," says Larry Gray, a partner at Rolla, Mo.-based Alfermann, Gray & Co. CPAs. "Make sure you have all the appropriate documentation and information," says Mr. Gray, who is also government liaison for the National Association of Tax Professionals.

To avoid a tax audit, the best thing you can do is file a return that is correct and complete, says Eric Smith, an IRS spokesman. When your return is right to start with, the chances that you'll hear from the IRS go way down, he says. Filing electronically is also recommended since you can amend and fix any issues more quickly.

Fewer than one million Americans get audited each year. But individuals who don't file their taxes, or underreport their income, are top of the list.

So what are the red flags on your tax forms that can trigger an audit? According to the IRS and tax professionals, here are 10 that can easily trip up filers.

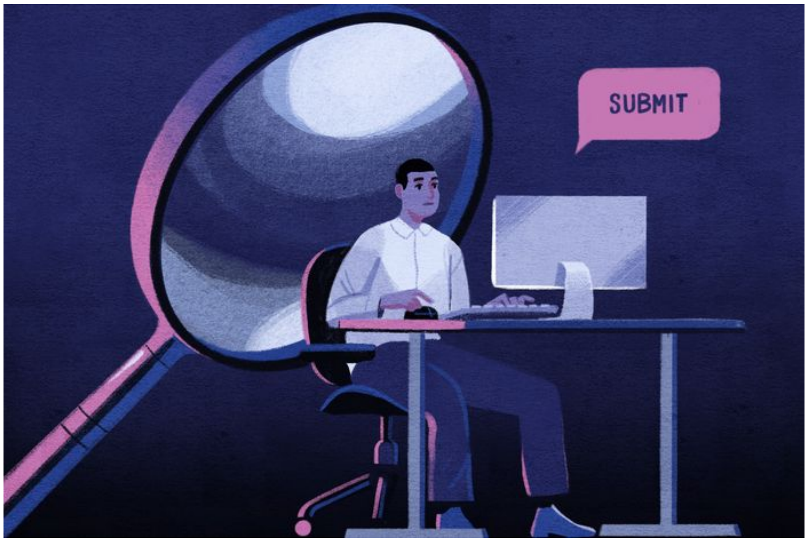
1. Education tax credits

Two types of education-related tax credits were issued last year: the $2,500 American Opportunity Tax Credit, primarily for students pursuing an undergraduate degree; and the $2,000 Lifetime Learning Credit for people pursuing a career change or advanced educational training at a postsecondary school. Both come with eligibility requirements. For example, the American Opportunity credit requires that the student be in school at least half time, and that the money be used for tuition, books and required fees—but not room and board.

"It's important not to claim the wrong tax credit on your 1040; we see this confusion a lot," says Bryan Cannon, chief executive of Cannon Advisors, a firm that does tax planning. "You also cannot claim both credits in the same tax year," Mr. Cannon says.

A tax credit is a direct reduction, dollar for dollar, in the amount of taxes owed, rather than a reduction in taxable income.

• **Red flags:** Claiming the wrong credit or both in the same tax year; claiming multiple tax breaks for the same college expenses; and not submitting Form 8863—used to figure and claim your education expenses.



The IRS is looking closely at how individuals account for early withdrawals from retirement accounts.

ILLUSTRATION: RYAN JOHNSON

2. Small businesses

Small businesses will get a lot of scrutiny from the IRS this tax season, especially S Corps, sole proprietorships and partnerships making $100,000 a year that are cash-intensive—such as restaurants, bars, grocery stores and beauty shops. It is a category in which excessive deductions and underreporting of business income are often suspected.

Proprietors and partners of small businesses also sometimes are tempted to declare artificially small salaries for themselves to lessen the tax impact on the company and themselves.

"Don't try to avoid paying payroll taxes by paying yourself a very low wage—the IRS computer system will pick up on that," says Mark Pendergast, a principal of Inspired Financial, a wealth-management and tax-planning firm in Huntington Beach, Calif.

Business owners who received emergency stimulus loans in the Paycheck Protection Plan under the Cares Act also should be vigilant. Those "loan amounts could be taxable income if the proceeds were used improperly," says Andrew Sherman, partner at Seyfarth Shaw LLP, a Chicago-based law and advisory firm. At least 60% of the proceeds were required to be used to cover payroll costs, utilities, rent and mortgage interest.

• **Red flags:** Failing to report all taxable income; taking low wages; overstating deductions; claiming high losses well above those in earlier years; not recording debt forgiveness; intermingling personal and business income and expenses; excessive travel and entertainment expenses; and amended returns.

3. Child tax credit

Adjustments to the child tax credit made in 2021 could trigger audits for several reasons. For eligible families, the credit increased to $3,000 from $2,000 for children ages 6 to 17, and to $3,600 from $2,000 for children under 6. In addition, as part of the American Rescue Plan of 2021, advance payments of up to one-half of the child tax credit owed were sent monthly to eligible taxpayers. About 60 million children were covered by advance payments starting on July 15, the U.S. Treasury Department says.

In their filings for 2021, taxpayers now must reconcile the amounts they were paid with the amount they qualified for. Some may have to pay back money they didn't qualify for, while others could get a bigger tax refund.

"This is one of the biggest audit triggers this year for millions of Americans, and at income-tax time there will be many surprises," says Jovan Johnson, chief executive of Peace of Mind Wealth Planning in Atlanta.

It is a sticky reporting issue because there is so much room for error for married joint filers, couples who got divorced or families that moved. "Checks could have gotten lost, and direct deposits in the account of one former spouse could have not been accounted for," says Marilyn Meredith, an enrolled agent who runs Meredith Tax Service in Port Huron, Mich.

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Further complicating matters, in January the IRS announced there were errors in some copies of its Letter 6419 sent out to credit recipients; in some letters, wrong amounts were shown for the payments that recipients had received. As a result, all recipients of the child tax credit are urged to go to IRS.gov/Account and the IRS Child Tax Credit Update Portal, where they can find the correct amount of their advance payment.

• **Red flags**: Inaccurately reporting the amount of the advance payment; misstating your income.

4. Cryptocurrency transactions

Anyone think the IRS isn't taking cryptocurrency seriously? The No. 1 question on this year's Form 1040 asks if you have received, sold, traded or disposed of any financial interest in a virtual currency. The IRS has a mandate to collect $30 billion in crypto tax revenue over the next 10 years, and is treating all types of digital currency as property for tax purposes.

"The IRS has seen the tremendous growth in this industry, but the number of people reporting their crypto income for tax purposes is not growing at the same rate," says Dan Hannum, chief operating officer at Zenledger, a crypto tax software company contracted by the IRS to track the cryptocurrency movements of U.S. citizens.

Tax filings related to crypto earnings pose challenges because most investors use several exchanges world-wide and 10 to 20 different digital wallets, Mr. Hannum says. It is up to individuals to aggregate all of this information on Form 8949. That's why many tax pros recommend crypto investors seek the help of crypto tax specialists. "Don't think the IRS can't track your activity on a digital wallet. That's no longer true," says Mr. Hannum.

• **Red flags**: Underreporting crypto income and any interest income from a crypto interest account or from a nonfungible token; and not listing all of your taxable trades individually.

5. Earned-income tax credit

Each year about 25 million low- and moderate-income Americans seek a refundable earned income tax credit (EITC). The amount they receive depends on many factors including if they have worked and earned income is under $57,414, have investment income below $10,000 in the 2021 tax year, are disabled, have a qualifying child, or meet other criteria. The maximum for the 2021 tax year is $6,728.

But billions of dollars of these credits are paid in error, according to the IRS. That's why the agency is scrutinizing claims to prevent fraud. For 2021 only, more childless couples qualify for the EITC and for the first time it is now available to both younger workers and senior citizens. To qualify, workers typically must be at least 19 years old and older than 64. Students under 24 don't qualify.

• **Red flags**: Claiming children who aren't the taxpayer's qualifying children; using an incorrect filing status; earning $10,000 of investment income or more; and overreporting or underreporting income.

6. Large charitable contributions

For charitable donations to be deductible, the recipients must be qualifying organizations such as religious organizations and nonprofits. But if the deductions are high compared with your annual income, they will be reviewed and perhaps audited by the IRS. Deductions for cash donations to charitable organizations typically cannot exceed 60% of a certain calculation of your adjusted gross income (the limit was expanded to 100% for cash donations in 2020 and 2021), and the limit is lower if the donation isn't cash or is made to organizations such as certain private foundations. For more details, see IRS Publication 526, Charitable Contributions.

• **Red flags**: Lack of receipts, canceled checks and written acknowledgments for any donation of $250 or more; inflated values for noncash donations, as well as failure to get appraisals; and not providing documentation for qualified charitable contributions from your IRA.

7. Rental income

Many people new to the rental business (and there are many, thanks to the rise of Airbnb) don't realize that all rental income is generally considered passive income, not active income. So if you have a rental loss for the year, because your operating expenses exceed your rental income, you cannot deduct it against your W-2 income. This is a common mistake filers make, says Mr. Johnson in Atlanta.

Another issue that trips up filers is attempting to claim deductions on a mixed-use rental property, which is a dwelling that is a personal residence and is rented part of the year. "The more you and your family use the property, the less deductions you qualify for," says Matthew Lincoln, principal of Lincoln Tax Professionals in Fredrick, Md. "You need to keep a log on the use of the property and keep receipts on any expenditures so you can verify your deductions if you are audited."

• **Red flags**: Underreporting rental income; claiming large rental losses as deductions; and excessive or vague deductions.

8. Home-office deductions

The home-office deduction might be a tax quagmire this year due to confusion over who qualifies. The Tax Cuts and Jobs Act in 2017 suspended tax write-offs related to home offices for employees of companies through 2025. That means millions of people who worked remotely last year during the Covid-19 pandemic aren't eligible. Only people who were self-employed in 2021 can claim the deduction.

The tax break is limited to income from the business and covers expenses for business use of your home, including a portion of mortgage interest, rent, insurance, utilities, repairs and depreciation. It also covers office supplies, postage, computers, cellphones and other things you use to run your business. If you did freelance or self-employed work during the year, you may qualify for a partial-year home-office deduction.

"But it must be a room exclusively and regularly used for business and to meet clients. If you are working on your laptop in the family room it doesn't qualify," says Rick Reynolds, an independent enrolled agent who used to work at the IRS.

The deduction could be disallowed if it was used both for W-2 work and self-employment work.

• **Red flags**: Claiming a large percentage of your home's space, and claiming a deduction if you are a W-2 worker.

9. Early withdrawals from IRAs or 401(k)s

The IRS is looking at these transactions closely, so individuals need to be clear on the rules. Payouts from a traditional IRA or 401(k) before age 59½ generally incur a 10% penalty on top of regular income tax. For Roth accounts, parts of early distributions can be taxable and the 10% penalty can apply. There are a few exceptions—for example, if you retire early at age 50 and you are a police or law enforcement officer.

The Covid-Related Tax Relief Act of 2020 waived the 10% penalty to provide relief to taxpayers during the pandemic but it was reinstated last year. Be sure to report and document (Form 1099-R) all taxable income. The IRS can cross-check any numbers you report on your tax return through its computer system.

• **Red flags**: Failing to report income from IRA or 401(k) distributions, and not including all documentation with your 1040.

10. Health premium tax credit

Many people last year qualified for tax credits to help them pay for their premiums on health insurance purchased through the government-run marketplaces. Recipients of this benefit must complete Form 8962 and submit it along with their tax return. This will show any differences between how tax credit they qualified for versus how much was actually paid to the healthcare provider. The result could mean a bigger refund or less tax owed, or the opposite if payments exceeded the credit allowable. Recipients can estimate their total allowable credit on healthcare.gov—search for "tax credit."

The process can be confusing, and eligibility requirements changed last year. Prior to 2021, people who had incomes up to 400% of the federal poverty level qualified. That has changed. For 2021 and 2022, some people with incomes of more than 400% of the poverty line can also get credits, depending on the cost of the policy. Individuals on Medicaid, Medicare or other federal insurance do not qualify.

"The biggest problems with this credit occur when taxpayers who apply for coverage in the marketplace underestimate their income to get lower monthly premiums. Then when they file their taxes they find out they have to pay a portion, or the entire credit, back to Uncle Sam," says Mr. Cannon. "It can happen if a person got a higher-paying job during the year."

• **Red flags:** Married couples who file separately, a category that receives IRS attention because of increased potential for mistakes and fraud; not supplying documentation if you received unemployment benefits; and not including the premium-tax-credit Form 8962 with your 1040.

Ms. Ioannou is a writer in New York. She can be reached at reports@wsj.com.

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Appeared in the March 7, 2022, print edition as '10 RED FLAGS THAT COULD TRIGGER AN IRS TAX AUDIT IN 2022.'