PacificCPE

COURSE
34452A

Navigating IRS Audits Successfully

Audits don't have to be intimidating—for you or your clients. This course walks through the audit process from the taxpayer's perspective, covering how the burden of proof works, what triggers scrutiny, and how to protect your clients' rights throughout. You'll learn practical strategies for delaying office audits when needed, avoiding common missteps, and handling situations where clients haven't been fully cooperative. Real-world guidance on IRS scam awareness and understanding tax basis issues rounds out this practical, field-ready course.

CREDIT HOURS 2 | FIELD OF STUDY TAXES | EXAM QUESTIONS 10

Start Course ↓ | Final Exam Copy ↓

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Copyright Notice

© 2026 Pacific CPE, LP. All rights reserved.

The materials in this course — including the text, illustrations, exhibits, examples, exam questions, and review questions — are the copyrighted property of Pacific CPE, LP. No portion of this course may be reproduced, stored in a retrieval system, distributed, or transmitted in any form or by any means (electronic, mechanical, photocopying, recording, or otherwise) without the prior written permission of Pacific CPE, LP, except for the personal, non-commercial use of the registered learner.

Pacific CPE, LP grants the registered learner a single-seat, non-transferable license to access this course for the purpose of completing the associated continuing professional education credit. Account credentials may not be shared. Group access requires a separate enterprise license.

This course is provided "as is" for educational purposes. While Pacific CPE, LP makes a reasonable effort to ensure the content is current and accurate, the materials should not be relied upon as a substitute for professional advice. Pacific CPE, LP disclaims all liability for any error, omission, or loss arising from the use of, or reliance on, the course content.

Questions about reproduction, licensing, or use of these materials should be directed to support@pacificcpe.com.

Publication Date: April 2026

TABLE OF CONTENTS

CHAPTER 01

Winning Your Audit 4

1.01 Beware Of IRS Scam Phone Calls And Emails 19

1.02 Dress Like Yourself 65

Test Your Knowledge 108

Final Exam Copy 115

Glossary 113

Index .....

Chapter 1: WINNING YOUR AUDIT

Chapter Objective

After completing this chapter, you should be able to:

- Identify the different types of audits performed by the IRS.

We call them audits; the IRS prefers examinations. Whatever term you use, it describes one of life's most dreaded experiences—having the IRS probing into your financial affairs.

This chapter deals with the types of IRS audits—both correspondence and face-to-face—that individuals and small business owners are most likely to face. The IRS also has a Large Business and International Division for auditing businesses with assets over $5 million, as well as a Tax-Exempt and Government Entities Division.

The IRS accepts the vast majority of individual and small business tax returns without question. Your chance of being contacted by the IRS about a discrepancy on your return in any one year is less than 1 in 200. But if you are self-employed, your audit chances are as much as five times greater than average.

As your income increases, so does your audit likelihood. And when your time does come, expect it to cost you—over 8 out of 10 people who are audited owe additional taxes. A few people get tax refunds after an audit, but don't count on it. The amount of money the IRS assesses in audits is 32 times greater than the amount given back.

Federal courts have long held that if the IRS determines at an audit that you owe taxes, there is a rebuttable presumption that the determination is correct. This means that you have the burden of proof when up against the IRS. Critics have said that it really means you're guilty until proven innocent. While this is the standard in audits, it is not the standard in court proceedings where the IRS has the burden of proof. If you take the IRS to court, the government must show that you were wrong on a disputed factual issue, not vice versa. (See Chapter 2 of course 34453B.)

HOW LONG DO I HAVE TO WORRY ABOUT AN AUDIT?

Generally, your tax return can't be audited after three years from its original filing date. If you filed before the due date, April 15, the three years starts running from April 15 of the year it was due. This general rule has a few exceptions, however:

- If you understate your income by 25% or more on your tax return, the audit deadline is extended to six years.
- If you file a fraudulent return, there is no time limit on an audit. Tax fraud is conduct meant to deceive the IRS, such as using a false Social Security number. A really big mistake, if done negligently, not intentionally, isn't fraud. The burden of proving fraud is always on the IRS. And the IRS seldom audits returns after three years even if fraud is suspected.
- The audit time limit period, called a "statute of limitations," starts to run only if and when you file a tax return. Nonfiled tax years are always open to audit. If, however, you haven't filed and haven't heard from the IRS within six years of the due date of a tax return, you have probably escaped the audit net.

Tip

Audit notices are usually mailed between 12 and 18 months after you file your return. Generally, if you haven't heard from the IRS within 18 months, you won't be audited. IRS audit notices are sent by first class mail and never by email or telephone contact.

The Internal Revenue Manual directs auditors to complete audits within 28 months after you file your tax return. Legally, the IRS has 36 months. The 28-month internal deadline is imposed, however, to allow 8 additional months for the IRS to process any appeal you might request.

These internal IRS time limits usually work to your benefit. Audit cases are often delayed within the IRS for various reasons—backlogs, agent transfers, postponements, complex issues, and lost files. The older your file gets, the more anxious the IRS is to close it. Auditors can be fired for missing the 36-month deadline, known as blowing the statute, but it still happens.

The Audit Burden Is on You, Not the IRS

An audit is the process by which the IRS determines whether you properly reported all income—from earnings and investments—and took the correct deductions, exemptions, and credits. If the IRS finds that you didn't, you will be assessed additional taxes, interest, and—usually—penalties. An assessment is the formal entry of a tax liability in your records.

To do its job, Congress has given the IRS wide powers to inspect your financial records and to ask you and others about your financial affairs, to determine whether you're cheating Uncle Sam. (I.R.C. §§ 7601 and 7602.) The IRS will investigate the items listed on an audit notice checklist given to you and scrutinize any other areas deemed questionable. And the law specifically places the audit burden on you to demonstrate that the information shown on your tax return is correct—think of the IRS as the Show Me state of Missouri. If your dispute gets to court, however, the burden shifts to the IRS under certain conditions (see Chapter 2 of course 34453B).

Proving the correctness of your tax return might not be that easy. The IRS wins over 80% of all audits, mostly because taxpayers can't properly verify the information on their tax returns. IRS auditors say that the biggest reason for adjustments is poor record keeping, not taxpayer dishonesty.

Stopping an audit once it begins. Once the IRS sends an examination notice to your last known address, the audit has begun. It's difficult to stop an audit. Even if you die, your spouse or the executor of your estate is obligated to carry on the audit.

You might be able to slow down—or even stop—an audit, however, if you ask for a transfer of your file to another IRS district. Audit transfers are discretionary with the IRS, and you need a good reason to get one—such as a location more convenient to that of your tax documents.

Example

Janiel, who lived in Pennsylvania but had a jewelry business in New York, received an audit notice for Pennsylvania. She requested a transfer to where her business was located. Janiel told the IRS that her records were at the business location in New York, which was true. The transfer was granted, but the New York office's audit plate was already full and the office never got around to Janiel's audit. The three-year statute of limitations expired and Janiel's worries came to an end.

WHAT TO EXPECT AT AN AUDIT

Will the auditor discover the money I made from playing the organ at weddings?

I lost my records in a move last year—what am I going to do?

Was I entitled to claim my mother as an exemption?

Will the IRS question my home office deductions?

Is the IRS going to put me in jail if they find out I've been cheating?

These are common taxpayer concerns. So, let's look at what really goes on when the IRS decides to audit you. We'll look at the two primary issues in every audit:

- Did you report all income?
- Were you entitled to the deductions, exemptions, and credits claimed?

IRS Publication 17, Your Federal Income Tax, explains the audit process—from the IRS point of view.

DO I HAVE TO LEARN TAX LAW TO WIN MY AUDIT?

The Internal Revenue Code, or tax code, contains 4,000-plus pages of very fine print. Add to that IRS regulations, revenue rulings, letter rulings, manuals, and official publications, all of which add another 100,000 or so pages of tax law. Finally, there are thousands of court decisions telling us how the tax laws should be applied in individual cases. The total number of tax law pages exceeds one million!

How will I ever understand the tax laws? You won't. But that might not be as much of a disadvantage as you might think. Tax law is so voluminous and complex, most IRS auditors don't know it well either. Moreover, the training and experience level of IRS personnel is declining while the law is getting more difficult to master. This means that auditors normally stick to predictable audit issues. A taxpayer with very high income or an intricate tax issue, however, might be assigned an auditor with more training and experience. But normally, if you are well prepared, you'll come out okay—experiencing the minimum damage—most of the time.

In a few hours, you can learn the basic tax law for your particular audit issues. And you can—and probably should—consult with a tax professional before taking on the auditor.

The truth is that most people succeed in an audit without knowing any tax law at all. This is because many audit issues are factual, not legal. The distinction will become clear as you read this chapter. And it's as important to know IRS procedures—the rules

of the game and your rights in dealing with the IRS—as tax law. This course explains the rules to follow and a psychology for dealing with the IRS as well.

Caution!

Getting a tax refund does not mean that your tax return won't be audited. Typically it takes 18 months after filing for the IRS to pick its audit victims. You might be audited or have to give any refund money you received back later—and then some.

AUDIT SELECTION—WHY ME?

You just got an examination notice from the IRS. Are you merely unlucky, or are there more sinister forces at work?

Computers and Classifiers—What's the Difference?

The IRS computer is to blame for most audits. Each year, your tax return data is sent to the IRS National Computer Center where it is analyzed by a computer program called the "Discriminant Function." Your tax return is given a numerical DIF score—the higher the score, the more audit potential the return has.

The DIF program is super secret—few people even in the IRS know how it works or why a return is given a particular score. Outsiders guess that hundreds of variables on a return are weighed by the IRS computer. One known variable is called "total positive income," which means everything you took in from your services and investments, before any deductions or exemptions. If this number is over $200,000, your chances of an audit triple (roughly). The key variable is most likely the percentage of your deductions compared to the national averages for your income bracket. For example, in a recent year, the average charitable deduction for taxpayers in the $50,000 to $100,000 income range was $2,881. So, if you're in that bracket and claim $21,555, don't be surprised to hear from the IRS.

Are You Claiming More Deductions Than the Norm?

One of the chief components of the IRS DIF scoring system is how close your tax return is to the norm of others with similar deductions. According to author and statistician Amir Aczel (How to Beat the IRS at Its Own Game, Four Walls Eight Windows Press), the IRS is most likely to audit you if your return shows a high ratio of deductions to income on three schedules:

- Schedule A, Itemized Deductions
- Schedule C, Profit and Loss From Business, or
- Schedule F, Profit and Loss From Farming.

Aczel claims that, as a rule, as your deductions approach 50% of your income, your audit likelihood rises. He lists precise ratios based on a study of 1,200 audit cases. For example, he claims that taxpayers filing a Schedule C are rarely audited if they claim expenses of less than 52% of gross business income, but are often audited when claiming expenses of more than 63%. If you include a Schedule A with your tax return, Aczel claims you're safe from an audit if your deductions are less than 44% of your gross income. While his book is interesting, don't use it as a manual to avoid a tax audit. If you're entitled to a deduction, it makes sense to take it, no matter what the chances of audit are.

Unreported Income DIF Programs

The IRS has a second computer scoring program to catch people not reporting all of their income. This approach is slightly different from the DIF program, which relies heavily on deductions and exemptions claimed. This program is called the "Unreported Income Discriminant Information Function" (UIDIF). It scores individuals based on a high-expense/low-income ratio. In plain English, the tax man is looking for folks who look like they are living beyond their means. For instance, you and your spouse report income from your jobs of $40,000 and you claim mortgage interest and real estate taxes of $35,000. Even assuming that you didn't owe any taxes that year, it would be tough to live on $5,000—so the IRS believes. Of course, some people have down income years and simply borrow or dip into savings to get by. These explanations can always be made to an auditor, if necessary.

One in ten tax returns—those with the highest computer scores—are initially selected for further review. IRS classifiers (human beings) then pass this batch down the line.

Local IRS Makes Final Decision

The final say-so on who gets audited face-to-face is made at local IRS offices. Examination group managers supervise and assign the auditors, often according to their experience and expertise. Managers decide whether you will be audited at the IRS office or will get the more rigorous field audit.

IRS field offices have their own audit-screening selection process which takes into account income and expense levels in their communities—for instance, people are more likely to claim car expenses for business in Los Angeles than Manhattan. Group managers select less than 10% of the returns received from the IRS classifiers—the 10% of all tax returns—to be audited. The net result is that in a recent year, only 0.5% of all returns were actually audited.

The IRS Looks at Significant Items

According to the IRS Manual, only significant items should be examined. What is considered significant depends on the IRS's overall view of the return as well as particular items that seem questionable. Factors that are likely to figure into the audit selection process include:

- Comparative size of an item to the rest of the return. A $5,000 expense on a tax return reporting $25,000 in income would be significant; the same expense on a return reporting $100,000 in income wouldn't be.
- An item on the return that is out of character for the taxpayer. A plumber claiming expenses relating to a business airplane would cause suspicion.
- An item that is reported at an inappropriate place on the return. For example, $2,000 of credit card interest is reported as a business expense. The IRS might suspect that you improperly deducted personal interest as a business expense.
- Evidence of intent to mislead on the return. Filing a tax return with missing schedules or not providing all information asked for on the forms raises an IRS classifier's eyebrows.
- Your gross income. The IRS scrutinizes higher earners. If you make over $100,000 per year, your audit likelihood is greater than the likelihood for the general population.
- Self-employment income. The IRS is most suspicious of people in business for themselves. Depending on their income, sole proprietors are up to five times more likely to be audited than wage earners.
- Losses from businesses and investments claimed on the tax return. If your business and investments show losses on your tax return, the IRS might want