Financial professionals offer tips on how to survive an IRS tax audit.

By Tonya Ratliff-Garrison
Illustration by Gabriel Trevizo

You open the mailbox and the return address on the envelope immediately jumps out at you: Internal Revenue Service.

With adrenaline pumping through your veins, you rip the envelope open and pull out the paper inside. Your heart stops. There’s the word you dread: audit.

But do not fear, say equine financial advisers Billy Peterson, C.F.P., and Carolyn Miller, C.P.A. If your records are in order and you’ve run your horse operation in a businesslike manner, then you should be able to survive a tax audit.

What to Do First
As soon as the IRS letter arrives, call your tax accountant.
“That’s the first thing you want to do because they can help you best prepare for an audit,” Carolyn said. “You shouldn’t try to take this on by yourself. Most accountants have gone...
through audits a lot of times.”

Billy also points out that a tax accountant will lend credibility to your effort in dealing with an audit.

“Talk to your accountant and make sure your stories are all straight,” he said. “You don’t want your accountant to say something he thought was the case and it really isn’t. You need to prep your accountant on all the things that are going on in your business, and be prepared to answer questions, because the auditor is going to try to learn as much as possible going into the audit.”

The most important thing is not to ignore the audit notice. You generally have 30 days to respond.

“There is usually a reply deadline date on the letter. You need to make sure you reply by that date and acknowledge the fact that you received the letter,” Carolyn said. “If you ignore it, the IRS can turn around and disallow all of your deductions and whatever else might be under dispute.”

When the IRS is contacted, the auditor will want to set up a date to meet. Carolyn stresses that the meeting should not be at your home, office or ranch.

“Try to get the place of meeting at either the IRS office or at the accountant’s office,” she said. “That’s very important, because if they meet you on your turf, they can snoop and ask you for a lot more.”

The notice will request records and items needed for the audit meeting.

“But if they ask for something that they didn’t previously ask for, you’re not under the gun to produce it,” Carolyn said. “But if you’re in your own office setting, sometimes it’s a little harder to control these types of requests because you’re supposed to have all of your records on hand.”

“If the meeting is in the accountant’s office or the auditor’s office, then you can buy yourself a little bit of time. You can say, ‘OK, I’ll get that and produce it by such and such a date.’”

Before the meeting, pull out the records that are being requested and make sure you have everything that might be needed to support your case.

“Hopefully, you’re an organized person who has things filed away and has a good set of records that can be produced for the meeting,” Billy said.

If you don’t have everything available, make sure you replace any missing records by asking for duplicates. Don’t arrive at the audit and claim the records are missing as this will not make you look good and could cause you to fail your audit.

What Triggered the Audit?

There are many red flags that can trigger a tax audit.

“Most IRS auditors feel you are getting into the horse business for a tax shelter – to get a loophole to write-off all your income from another job,” Billy said. “You have your business or job that you do well in making a lot of money and all of a sudden in your tax return that you file, you have a whole lot of expenses from a separate business that you’re claiming. That’s an immediate red flag when they see a disproportionate amount of expenses to go along with a normal income.”

The reason for the IRS audit is most likely to determine whether your operation is a legitimate business or a hobby.

“In a hobby, you might tend to use gut and heart in your decisions,” Carolyn said. “In a business, you use a practical business mind.”

Any business will have a detailed plan that gives realistic expense and profit projections. A horse operation, no matter whether it is set up for boarding, breeding, racing or showing, must have the same.

“If you’re going into the bank and want to borrow some money to start a business, you don’t walk in there and say, ‘I’ve got a great idea,’ and try to tell them by giving them the picture orally. You have to have it in writing: Here’s how much it is going to cost me to get set up, here are all the expenses you anticipate, and here is how you intend to make a profit.

“You have to have things laid out. It doesn’t have to be a 20-page document. You can have a two or three-page business plan that says here’s how you intend to make a profit.”

And make sure you separate your business records from your personal records.

“From my experience in the financial world and talking to CPAs, they tell me if you have a separate entity, name and tax ID number, all of those things are going to reduce your odds of having an audit,” Billy said. “A lot of people make the mistake that they have their one checking account they use for everything in their personal life, and they just use that for their operation. And that’s a mistake.”

A big mistake, Carolyn adds.

“The IRS really frowns on mingling your personal funds with business funds,” she said. “That is a big tick against you. If you commingle your expenses, the IRS will say this is a hobby. If you go to any business, they are all going to have business accounts. You should have a business account, too.
I also recommend getting a business credit card.”

**What to Expect**

**THE AUDITOR MIGHT HAVE A TELEPHONE CONFERENCE WITH YOU before the meeting.** Billy encourages your accountant to be a part of this conversation also.

“From my experience, they will ask you a few questions and try to keep things close to the vest. They won’t tip their hand of all the things they are going to ask,” he said.

At the meeting, the auditor will attempt to trip you up with questions about your horse operation.

“He wants to back you into a corner and try to find some level of false information in what you’ve provided in your tax return. They are going to ask you a lot of silly questions and try to act like they know what they are talking about, and a lot of times they don’t,” Billy said. “Brush up on your return so you’re familiar with what you’ve recorded and are ready to talk about it and answer all of their questions.”

The auditor is going to ask pointed questions about your operation, such as:

- Why have you chosen these people to train your horses?
- How are these expenses implied?
- Have you relied upon any experts or advisers?
- Describe how active you are in the day-to-day operation.

“You’re going to have to lay out here’s why I did this and why I did that,” Billy said. “Here’s my reasoning. Here’s why I’ve entered into these races.”

Don’t be a jerk and take out your frustrations on the auditor. Remember, he is just trying to do his job. Be courteous at all times, even if he seems impolite or unreasonable.

“Auditors are human beings, too,” Carolyn said. “Some of them are pretty hardnosed and go by the book with the ruler out, but I’ve also met some very nice auditors who will let you have time to get something. I find if you’re well-prepared and come in with everything they want, it really helps turn the tide in your favor.”

**What to Bring**

**WHEN YOU ARRIVE AT YOUR AUDIT MEETING BE ORGANIZED and prepared.**

“Good recordkeeping is essential,” Billy said. “Every year, you should have a new set of records. Keep all your receipts, and once the year is complete, take all of your records and set it in one of those tax file boxes. Keep everything separate – training bills, entry fees, sales expenses and transportation expenses. If you are audited, they will want hard copy proof. In addition, keep well-maintained computer records for your own information.”

The more organized you are, the better you are going to look to the auditor.

“If you come in with a box and spend half the time rustling around looking for something they’ve already given you a week or two to prepare for, you’re not looking very prepared,” Carolyn said. “This doesn’t look good in their eyes and is going to turn them off. You’ve got to be businesslike.”

There are many computer programs available to help keep expenses organized.

“I have no problem with someone bringing in a manual ledger. If that’s what they are going to keep most accurate, then I recommend using it,” Carolyn added. “But I really don’t want to see is a client who keeps his books in such a fashion that he just throws receipts in a box and totals them up at the end of the year. You’re supposed to monitor your business, and if you keep records in this fashion, you won’t be able to show that you were doing that.”

During the meeting, the auditor will ask for your business plan.

“If you have this confused, dazed look on your face, it will be a dock of points against you,” Billy said. “They will think then that you really haven’t gone into this as a business.”

If the original business plan has been revised, bring the original and each revision to the meeting.

“I tell my clients not to use a business plan as just a static document. It should evolve over time,” Carolyn said. “At the end of the year, do some synopsis. That way, if audited, you can show that you were keeping track of your expenses and making changes as needed, no matter if it was a bad economy or a mare slipping a foal. Showing that is going to go in your favor: This person is acting in a businesslike manner.”

**What If You Lose**

**IF YOU DON’T PASS YOUR AUDIT, YOU CAN APPEAL THE DECISION.**

“This is where you really need to go for expert guidance, though, to determine if you have a strong or weak case,” Carolyn said. “If I look at your case and I’m convinced you have carried this on like a business, then I would say, ‘Yes, let’s file an appeal.’”

Tax appeal officers are more senior than audit agents. If you’re making a specious argument the tax law doesn’t support, the appeals office will quickly dismiss it. However, if you can show your issue is founded in tax law and court cases, the appeals officer can find in your favor.

A few years ago, Carolyn was approached by a horse business owner who had lost his audit and had his claims disallowed.

“He had done the audit on his own, and when he lost he sought the help of a lawyer, who told him he needed to get an accountant,” she said. “We ended up going to U.S. Tax Court and won. Everybody who looked at the operation with an objective vision could see this is a professional operation. But it did cost him a lot of money because he had to hire all these people to defend him.”

The owner’s best bet, though, would have been to hire a finance professional when he received the audit notice.

“If he had, he might not have had to go through all the heartache, aggravation and stress of an appeal,” Carolyn said. “The tax code has become so complicated; you’re not likely to know the law or your rights as a taxpayer. However, a tax professional does know and will know what to do. It will be worth every dollar spent.”

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