

Messy Money: 9 Ways to Avoid a Tax Audit When Getting Divorced

Turbulences in relationships can turn critically ugly. Even though you wouldn't like to read these words, complications can eventually lead to a divorce. The harsh reality is divorces in the US are much more frequent than you can imagine.

Before we proceed to the nitty-gritty, let's take a look at these numbers.

- A report published by CDC reveals that the ultimate outcome of more than 50% of relationships is a divorce.
- Around 41% of first marriages and 60% of second marriages end in divorce.
- A divorce takes place every 13 seconds in the US.
- On average, a marriage lasts just eight years.

Divorce cases turn out to be mentally stressful. Undergoing a tax audit can further complicate things. Now, you might be wondering what's the ominous connection between a divorce case and a tax audit, right? We will quickly take you through the formalities before recommending you a few strategies that can help you avoid a tax audit.

Remember, an IRS tax audit can haunt you for years if the authorities smell a rat, suspecting you as a fraud. Being a divorcing person, make sure to understand what a tax audit involves and what countermeasures you can take to avoid a tax audit.

What is a tax audit?

IRS carries out tax audits to scrutinize whether the return information furnished by taxpayers is accurate. Every year, more than 230 million tax returns get filed. In 2021, the gross tax collected by the IRS amounted to \$4.1 trillion. To ensure transparency and accuracy in taxation, the IRS has come up with advanced statistical protocols. These computerized systems are capable of detecting incorrect information furnished by taxpayers.

Since many taxpayers try to hide their income sources, the IRS deploys various tools to detect reporting irregularities. In case the IRS flags a taxpayer's return, they determine whether or not they should scrutinize the matter, triggering a tax audit in the process.

In case you fail to report revenue or hide your income, the IRS examiner may issue a tax audit. Tax audits come under three categories: field audits, office audits, and correspondence audits.

How are divorce cases related to tax audits?

Now, you might be wondering why divorce cases and tax audits share some sort of relationship.

A spouse undergoing divorce would naturally hide assets or be reluctant to disclose full income. This would mitigate the person's liabilities during property division while the divorce case proceeds. As a result, inconsistencies show up in the current financial statements. This prompts the judge to inform the IRS about the discrepancies.

The IRS, on examining the financial details of the spouse, may conduct an audit to find out whether or not the tax filings

have been honest and transparent. Therefore, it's out of ethical obligation that the judge informs the authorities of the discrepancies, who issue an audit.

In case you try to hide income sources or report less income than you actually have, you can face legal consequences.

9 steps to avoid an IRS tax audit

Divorce cases are typically hostile. These cases often expose financial discrepancies, and one spouse can land in legal trouble. The best way to avoid a tax audit is to go for a divorce mediation outside the court. This way, you can arrange a private setting to sort these inconsistencies out and ease up your finances.

However, not all divorce cases are mutual, so you don't get the scope to settle things outside the court. The best line of defense against a potential tax audit is to be honest with your tax filings.

We have recommended these guidelines to help you avoid or survive a tax audit.

1. Report all your income

Being transparent while reporting your income sources and earnings ensures that you won't be caught off-guard during a tax audit. It's a bad idea to forget or overlook income sources, regardless of how little you make from them.

- The IRS would want to see your non-employment income on your return. So, make sure not to omit the 1099s on your IT file.
- Do you indulge in sports gambling or any other type of betting? Try not to hide any winnings or losses.
- Report your interest and capital gains if you are an investor. Remember, the IRS has its own means of

obtaining all your information. Even if you try to hide them, the authorities will eventually find out.

- Report your foreign income, even if it seems to be negligible.

Being honest with your report would project a responsible profile to the examiner. This can substantially reduce the chances of an audit.

2. Avoid mistakes and amends

Do you know that even a small amendment on your tax file can trigger an audit? Try not to make careless mistakes while filing your returns.

Especially if you are engaged in taxi driving, bartending, or any cash-based business, document your earnings carefully. Committing a silly mistake can prompt you to amend your return, drawing suspicion from the tax authorities.

With your financial situation already tense amidst your divorce proceedings, you won't like to further complicate issues. Tax authorities would be extra-vigilant about you, given that you are one of the divorcing spouses.

The worst mistake would be overlooking an income source from which you have generated substantial money. Amidst your emotional turmoil, it's easy to miss out on financial details. Consider hiring a professional tax preparer to stay out of the woods.

3. Don't go for bad advice

Each time you fall for a piece of bad advice, you're risking yourself. Undue advantages are not worth taking when going through a divorce process. Try not to report anything illegal or fraudulent. When considering the permitted deductions, bad advice would be available in plenty.

- For instance, a taxpayer might consider casual new clothes as deductible. However, you must note that new clothes are tax deductible only when you wear them for a job. Nurses' scrubs, for example, qualify for tax deductions.
- Likewise, taxpayers can deduct their home offices only when they use the space exclusively for self-employment work.

Knowing what qualifies as a deductible is crucial in the first place. With the chances of a tax audit high during divorce proceedings, ensure not to take undue risks.

4. Avoid inflating business expenses

Refrain from exploiting loopholes in the system while filing income tax returns, as this can backfire. Of course, taxpayers report business expenses. However, don't report anything that you can't justify or validate later. Adhere to the IRS rules and keep all the documents with you.

- Taxpayers are eligible to deduct costs associated with home office equipment and supplies.
- In case you are using a car for business purposes, deduct only the work mileage. The IRS would consider the standard business mileage depending on your profession. So, don't report thousands of business miles driven if your profession doesn't involve much travel.
- Try not to include entertainment costs or bills for restaurant meals unless you have documents to prove your case.

In a nutshell, keep all your bills, invoices, and receipts organized for your defense.

5. Be vigilant while claiming for

dependents

Remember, not all your children can qualify as your dependents. In case you file returns considering them as your dependents, a tax audit might leave negative consequences.

Particularly, when divorced parents share the custody of a child or file taxes separately, be careful about who claims the deductions. Unless there's a joint tax filing, you are not entitled to claim for your children separately.

Besides, parents cannot claim deductions for their children after they turn 19. However, if your child continues to be a full-time student, you can claim a deduction.

6. Distinguish your contract workers and employees

If you are a business owner, ensure not to mix up payments made to independent contractors and employees. Often, entrepreneurs end up categorizing everyone as contract workers. This eliminates the hassles of dealing with the W-4s and W-2s or withholding income taxes. You would land in trouble if the IRS considers your contract worker to be a full-time employee.

Remember, contract workers uphold their status of a freelancer or independent professionals by undertaking projects whenever they want and with whoever they prefer. You simply have a say when it comes to quality assurance. Your contract workers become employees when you start dictating when to work or specific tools to deploy.

7. File real estate business income and rental losses accurately

Do you have a rental property? You can't write off the chances of incurring losses, but this would be acceptable only for a

few years. When you habitually start real estate losses and show them on your IT file, it might trigger suspicion.

Only ordinary income tax rates are cut through the Tax Cuts and Jobs Act. When you sell the property, the long-term capital gains tax will apply. Things become complicated when you incur rental losses. According to the existing policies of the IRS, a taxpayer can deduct a maximum of \$25,000 for rental losses. However, you can deduct this amount if you actively rent the property out.

Besides, try not to claim yourself as a real estate professional unless you really are. The IRS requires you to spend more than 750 hours per year before they start considering you as a real estate professional. If you do want to make such claims, document every hour that you channel to your property business.

8. Take care of your credits and deductions

As a taxpayer, it's tempting to fall for credits and deductions since they slash your liabilities and taxable earnings. However, if you are going through a divorce, it's wise not to exploit them. The examining authorities are aware that these are largely exploited provisions. Considering your marital status, they would dig discrepancies out.

To simplify your tax filing process, here are a few guidelines.

Don't file claims for large itemized deductions. The IRS will definitely notice if your income and deductions are not synced properly.

Unless you are eligible, don't go for the Earned Income Credit.

When it comes to mortgage interest deductions, try not to hide

things. The IRS would obtain a copy of these forms, so there's no point in being dishonest.

Self-employed professionals often get carried away while deducting equipment, supplies, and associated costs. Deduct costs you can justify through documentation in case of a tax audit.

Don't exploit the American Opportunity Tax Credit. This credit allows you to get returns on taxes you shell out for higher education. Remember that you can claim it for just four years while completing your higher education or a degree. Besides being enrolled half-time at least, there are other obligations to be fulfilled.

9. Be vigilant while claiming charitable contributions

Just like business deductions, try not to inflate charitable contributions. When you undergo a divorce, the IRS would be overly meticulous while scanning your financial dealings. It would be wise not to include your political contributions as charities. Also, keep proper receipts for all your donations or goods you purchase for charitable purposes. This includes:

- The value you donated for charity (not political purposes)
- If you received a return for this contribution, keep the receipts
- The papers should mention the value of the amount that you received

It's tempting to include contributions you made to politicians as charities. However, don't list them under charitable deductions since the IRS would definitely pull you out for these.

Endnote

Here are a few more tips to help you through your divorce.

- Make sure to file your taxes before the deadline. Even if you don't owe any tax or have incurred a loss, it's wise to respect the norms.
- Maintain a separate log for employee expenses and car mileage.
- Also, keep receipts of your HSA distributions.

Well, we understand you are already messed up with your relationship and personal life. Don't let your financial life take the backseat! You would be bracing up to move ahead after your separation. Respect financial norms and remain transparent with your files to sustain a tax audit or avoid a tax audit, even if the worst comes!

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