Avoiding an Audit

(or making it less painful if you do get audited)

Be aware: The IRS has resumed its practice of conducting random audits as a way to evaluate its audit selection criteria. Burdensome complete audits of taxpayers are rare. Random selection, however, makes these audits hard to avoid.

Here are some automatic problems:

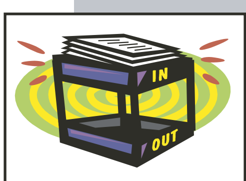
Missing information

- The IRS will contact you if you omit identifying information or information required to compute your tax. Missing social security numbers are typical (including the social security numbers of dependents and ex-spouses who are receiving alimony from you).
- This probably doesn't change your odds of a real audit unless you can't or won't comply with the IRS request to supply the information or there is something else glaringly wrong with the return. If all goes well, your return will just go back into the "pile" to await possible selection in the normal audit "lottery."

Math error procedures

- If the return contains a math or clerical error, the IRS may assess and send a notice of additional tax due without following the normal tax deficiency procedures.
- If you are claiming certain credits that require a Taxpayer Identification Number (TIN) on the tax return, make sure the information that the TIN issuer has is correct. If there is a discrepancy between the number you provide, and that provided to the IRS by the TIN issuer (such as the Social Security Administration), the IRS will assume that the information provided by the TIN issuer is valid and treat your return as if you omitted a valid number. The IRS can then use the math error procedure to summarily assess any additional taxes due as a result of the disallowed credits.

Items not toclaim

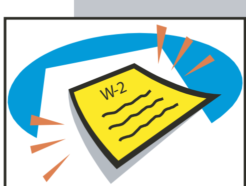


- The IRS will automatically disallow the following as contrary to law:
  - losses on the sale of your home or personal property
  - surviving spouse filing status for more than two years
  - medical deduction for (a) unnecessary cosmetic surgery, (b) funeral expense, (c) diet foods
  - itemized deduction for the following taxes (a) FET on tires, (b) car registration (vehicle tax based on value is deductible), (c) import duties (and others)
  - personal interest expense deduction (except on a qualified home mortgage)
  - personal insurance expense deduction, except medical, long-term care
  - moving expense deduction in excess of legal limit

Married filing separately

- Both must itemize or both must take the standard deduction.

W-2s and 1099s



- Make sure you report the exact numbers you get on your W-2 wage statement or 1099 statements of interest, mutual fund gains, dividends, gambling winnings, pensions, etc. The IRS can match these to your return and a discrepancy can trigger an audit.
- If you get a W-2 or 1099 that is in error, immediately try to have a corrected form filed. Discrepancies between information on your return and tax forms are a red flag for the IRS.
- If you are required to divide the numbers up between various lines on your return or the numbers are wrong, be sure you can explain (and get the issuer of the statement to correct errors).

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Source: CCH, 2006
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The IRS has access to a lot of information beyond your return and beyond W-2s and 1099s. For example:

Partnerships, S corporations, trusts

- Make sure your return is consistent with the return of any partnership or S corporation you are a part of; any trust you receive income from, etc.

Prior dealings with the IRS

- If you have been audited before, the IRS will remember. Don't repeat past mistakes.
- If you have requested a ruling from the IRS, make sure your return is consistent with the ruling – unless you want to go to court on the issue.

Tax items that affect more than one year

- If you took depreciation on a piece of property and you've now sold it, make sure that the gain or loss you report this year is consistent with the costs and write-offs you reported in previous years.

Here are some common problems that could come up if you are audited:

If you own rental property

- If you live on the premises, do you keep personal and business expenses separate (including depreciation)?

Job-related expenses (unreimbursed)

- Do you have proper records?
- Did you properly deduct meals and entertainment expenses (usually 50% is allowed)?
- If you used a car or computer (or other property) partly for work and partly for pleasure, did you deduct only the work portion of the expense?

Job-related expenses (reimbursed)

- There shouldn't be a deduction unless the reimbursement failed to cover the expense.
- Was the reimbursement under an "accountable plan" maintained by your employer? Did you have to give the records to your employer and was the reimbursement limited to the expense, as required?

Tips

- Are you in an occupation that normally receives tips (waiter, cab driver, porter, beautician)? The tips you report should be reasonable, given the type of job and the hours you devote to it.

Unusually large interest expense

- Are you taking a large interest deduction without the apparent funds to repay the loan? The IRS will suspect you are receiving income without reporting it.

The IRS is currently focusing its limited audit resources on offshore credit card abuse; high-risk/high-income taxpayers; abusive tax shelter schemes and their promoters; non-filing by high-income taxpayers; and earned income credit abuse.

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If you have a business, here are some items the IRS looks for:

Completed returns prepared by professionals

- A return that is complete, has all schedules in place and is prepared by a professional is less likely to be audited. (The IRS does rely on your accountant's unwillingness to do certain improper things.)

Related corporations have higher audit risk

- Don't think you can put one over on the IRS by creating multiple corporations. Groups of corporations under common control are more likely to be audited.

Small businesses

- Small businesses tend to lack "internal controls"—accounting systems that the IRS can rely on.
- If you are worried about being audited some day, put a good accounting system in place today. And stick to it. The IRS will take that as a sign that you are making an effort to comply.

The IRS will know your business

- IRS auditors are becoming more knowledgeable about your specific business. (The MSSP program is part of this.) They will know what to expect on your return and what is bogus. The restructuring of the IRS into units that serve groups of taxpayers with similar needs (individuals, small businesses, large businesses and tax exempts) is likely to improve the agency's ability to scrutinize taxpayer activity.

Fringe benefits

- There are strict rules for health insurance, life insurance and pensions to assure that the expense is a business expense and not a personal expense solely for the welfare of your family.

Employment taxes

- The IRS takes a dim view of classifying employees as "independent contractors," just to avoid withholding taxes and other obligations.
- If the IRS finds that you've issued a lot of 1099s rather than W-2s (or worse–you didn't issue any statements but attempted to deduct the expense) for this kind of work, you'd better be on solid ground for your "independent contractor" classification, or the IRS will sock you for a lot of back tax and penalties.
- A growing concern for the IRS is companies' attempts to avoid liability for employment taxes for independent contractors by maintaining the employee works for the customer, not the company. Although recent cases have upheld the classification of certain employees as independent contractors without the filing of 1099s, the IRS is paying very close attention to this area.

Lots of money or investments in the business

- There are special taxes to prevent you from holding excess money in a corporation or running your personal investments there. The IRS will see this on your balance sheet.

Tax-motivated transactions

- The IRS is on the lookout for transactions undertaken soley for tax avoidance with no business purpose.

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