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IRS audits on the rise

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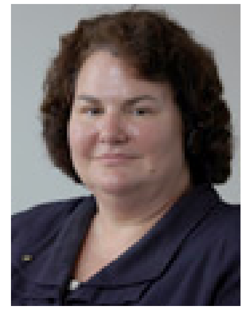
Agency gets aggressive about closing the "Tax Gap"



Many people would rather have a root canal than undergo an IRS audit. And with the number of audits on the rise, increasing numbers of business owners and individuals may have to confront that fear

The IRS does two types of audits. A "field audit" is the traditional, sit-down audit with an IRS agent. A "correspondence audit" is one in which the requested information is mailed in to the IRS agent, with no physical presence required. In addition, the IRS engages in "Document Matching", which is matching W-2's, 1099's, K-1's, etc., which are issued by third parties, to an individual or a company's tax return.

The IRS Restructuring and Reform Act of 1998 prompted the most comprehensive reorganization and modernization of IRS in nearly 50 years. Most of it was completed from 2000 through 2002, during which the IRS did not have as much time to allocate to audit activities. Congress had also cut funding for audits.

The number of field audits for fiscal year 2006 for individuals are up substantially from 2000, although not as high as in 1997 (see chart below).

	FY 1997 (1)	**FY 2000**	**FY 2006 (2)**
Field Audits, individual	715,615	251,108	302,959
Correspondence audits, individual	803,628	366,657	990,722
Business audits	103,004	49,574	52,223

(1) Federal fiscal year ends 9/30.
(2) Preliminary results

Correspondence audits have almost tripled since 2000, surpassing 1997. These audits are easier to do now since the document matching by the IRS makes it simpler to zero in on any suspicious numbers.

Closing the Tax Gap

The United States has a largely voluntary tax collection system. However, we all know some people who work "under the table," don't report all of their income, or exaggerate their deductions.

The projected budget deficit for fiscal year 2006, which ended September 30, is $390 billion. Tax law compliance could reduce this deficit considerably, so the IRS' goal is to shrink the so-called "Tax Gap."

The "Tax Gap" is the difference between what taxpayers should pay and what they actually pay on a timely basis. It has three major components. Underreporting income accounts for 80 percent, underpayment of taxes for 10 percent, and non-filing accounts for the other 10 percent. Underpayment of taxes is defined as not being able to pay the tax that you acknowledge to be due.

Individual income tax constitutes two-thirds of the Tax Gap. For individuals, 80 percent of the Tax Gap comes from underreporting income, not overstating deductions. Most of the understated income comes from business activities, not wages or investment income. Compliance rates are highest where there is third-party reporting or withholding, for example, wages, interest and dividend income. Less than 1.5 percent of wages and salaries are misreported.

Besides the Tax Gap caused by legal income, there is another tax gap, possibly much larger, that is caused by illegal income, such as drug dealing, illegal gambling, prostitution, and other activities that are not reported on any tax returns.

IRS Commissioner Mark W. Everson has increasingly targeted high-income taxpayers for increased audits (see chart).

Business income and rental income are more likely to be audited because there is much less third-party reporting. Although 1099s must be issued to individuals and partnerships, a business does not need to issue a 1099 to a corporation. In addition, a 1099 does not need to be issued even to an individual or a partnership if the amount paid is less than $600. Many taxpayers incorrectly misinterpret this rule to think that if they receive $500 from someone for doing some work, that they do not have to report it. This is false. Just because the IRS does not receive notification of income paid to the taxpayer does not relieve the taxpayer from reporting that income. During an audit, when the IRS agent asks for a copy of all of the bank statements that the taxpayer has, deposits to each bank account have to be accounted for. If you deposit money that you earned but did not report on your tax return, you will owe money at the end of the audit. If instead, you only accept payment in cash for work, there are other ways that the IRS can determine that you are not reporting all of your income.

U.S. audits, FY 2005-2006

Category being audited	**2005**	**2006**	**% change**
Individual income $1 million or over (1)	12,835	17,015	+32
Individual income $100,000 or over (2)	219,208	257,851	+18
S Corporations (3)	10,417	13,984	+34
Small C Corporations *(assets under $10 million)*	17,858	17,871	-
Large C Corporations *(assets $10 million and higher)*	10,829	10,591	-2.2
Partnership returns	8,489	9,777	+15
Exempt organizations (4)	4,036	7,079	+43

(1) One out of 16 individuals in this category were audited
(2) Represents the highest figure in over a decade
(3) Highest level since 2000, from 5,000 randomly-selected 2003 and 2004 tax returns
(4) Exempt organizations may be exempt from taxes but are not exempt from audits.

Source: IRS

Preparing for an audit

If you or your business is selected for an audit, the best advice is to prepare thoroughly. Have copies made of everything requested for a correspondence audit. If it is a field audit, the agent will examine the information requested at the site, and only ask for copies of items that he or she needs.

If a tax professional prepared the return, you will probably want that person to be present at the audit. If you no longer use that professional or prepared the return yourself, you may choose to hire another CPA or tax attorney. A Power of Attorney signed by the taxpayer and the professional is required to give the professional the authority to represent you. Normally, the taxpayer is not required to be present, although sometimes the agent will wish to see the business location or meet the taxpayer. You can represent yourself, although it might be like representing yourself at a criminal trial, when most people prefer to have an attorney to handle the questions. The professional has usually been through an audit before and is less likely to be nervous.

As long as you have all of the documentation, have reported all income, and not overstated expenses, the audit should go smoothly. Most audits occur one or two years after the year being audited so it is important to keep records. We advise clients to keep tax records for seven years. Normally, the IRS will only go back three years, but if they find something wrong in those three years, they will go back another three years. If you have committed fraud, there is no statute of limitations so the IRS can go back as far as it wishes.

Sometimes, there is a difference of interpretation of the tax laws. You may have depreciated a fixed asset over a number of years that the agent feels is too short. You may have claimed a loss from an S Corporation that the agent feels you are not entitled to take because you have not invested enough capital or loaned enough money to the business. You may have taken a charitable deduction for a work of art given to a museum and the IRS's appraiser has a different value for the art than your appraiser. A business may have improperly calculated the domestic production activities deduction or understated inventory.

The audit is always subject to the taxpayer's approval and the approval of the agent's supervisor. Even if your tax professional has the Power of Attorney, you will be consulted before agreeing to any increased tax. If you disagree with the results, you can always appeal to a higher level. Although there are time limits, to appeals so you need to be sure to meet those. The Tax Court is usually the highest level of appeal, although some cases can go as far as the Supreme Court. Once you exhaust the appeals process, you must pay the tax owed plus interest. There may also be penalties assessed against the taxpayer. Sometimes a preparer penalty is assessed if the preparer should have known better.

You may be asked at the beginning of the audit if you discovered any income during your preparation that should have been reported. If you say no, even though you are aware of something that wasn’t reported, this may make you more subject to penalties.

Often the most difficult part of an audit is the time and cost it takes to prepare for it, and the fees paid to the professional to participate in the audit. Even if an audit comes out to a "no change" audit or a refund is given. You have still invested time and money in preparing for the audit.

Every individual taxpayer and business taxpayer is entitled to take all appropriate deductions and to pay the least tax possible, as long as it is legal. The moral of the story is to pay as low a tax as legally possible, but don’t go beyond what is reasonable.

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