

STEER CLEAR OF AUDITS

With the Federal budget and Federal deficit at all time highs and no politician willing to mention tax increases, the Internal Revenue Service is beefing up their efforts at collection. As the IRS continues to boost its enforcement efforts, audits are occurring more frequently and usually for a reason. The IRS won't disclose the formula it uses to trigger audits. While some audits are random, the majority of audits are targeted, that is, they happen for a reason. You can never be 100% sure you won't be audited, unfortunately. BUT there are ways of protecting yourself and minimizing any problems. Here a few items to decrease your chances of audit and increase your chances of surviving an audit.

- 1. Report Your Income and Deductions Honestly and Accurately.** Easy, right? Its all right there. Accurately report all of your taxable income, not just what you got in the mail on a form. Include income from all sources such as capital gains, side jobs and alimony payments. If you miss income, the IRS will wonder what else you missed.
- 2. High income.** Not only are your taxes higher, but so are your chances of being audited. High earners should be aware that the government is eyeing their returns very carefully. That means make sure you have your support for your claims.
- 3. Speed Counts in Only One Direction - Against You.** Hurry up and filing may get you attention. Filing late may get you attention. Pushing for your refund definitely gets you attention. I always like to think about whose attention I want before I seek it. Get it done, on time and be patient.
- 4. Understand the Man.** Once you file, the IRS calculates what it calls your Discriminate Information Function (DIF) score, which rates the probability of inaccurate information on the return. They also calculate an Unreported Income Discriminate Information Function (UI DIF) score. So if you have a huge mortgage but little taxable income (and that mortgage payment is right there for them to see on the same document), you might earn a dangerously high UIDIF score. Returns with the highest DIF and UI DIF scores are the most likely to be selected by the IRS for audits.
- 5. Have Some Sympathy.** The IRS is not against you. Nor are they for you. Simply put, the IRS is the collection department for the federal government. Have you ever had contact with a collection department you like? You will like this one least of all because the laws are written mostly by their boss - Congress.
- 6. Schedule C.** In general, filers of Schedule C, the form used to report income or loss from a sole proprietorship, are among the highest audit risk group. Only claim what you can support with a paper trail.
- 7. Home office deductions.** If your place of business is also your residence, be careful with that home office deduction as the rules can be very tricky. A professional can guide you here, but be prepared to prove your claim. Get out your tape measure because the deduction is limited to actual deductions or the actual space your office occupies. Also, a home office deduction cannot result in a loss. You can, however, carry that excess loss over to the next year provided you have sufficient income then.
- 8. Hobby losses.** If you run a business that consistently turns a loss, you may be targeted for an audit. While you can deduct business losses in excess of income from the particular business, but you cannot deduct hobby losses in excess of hobby income. The critical focus here is your business intent and result. Sorry race horse owners - if your horse doesn't win, you might have a problem.
- 9. Itemized deductions.** The IRS is more likely to scrutinize returns with itemized deductions than those that take only the standard deduction. The agency keeps a range of "normal" deductions for each tax bracket based on the average claim taken. So if half of your income pays your mortgage interest, you might get an unwelcome knock on your door. Claim all deductions that you can legitimatize and hold on to your receipts.
- 10. Casualty losses.** Losses less the insurance reimbursement less \$100 must exceed both 10% of your adjusted

gross income. Confused? If so, get help. If not, take your deduction. Remember too that your deduction is based on the cost of the item, not its value - in other words, you cannot deduct “appreciated” value.

11. **Mistakes are attention getters.** Fix any mistakes you catch before the IRS catches them. It is better to call attention to your innocent mistake by fixing it than by hoping they don’t notice.

12. **Neatness counts.** Use computerized forms or, if you have to fill in your tax forms by hand, use good penmanship. If the IRS cannot decipher your numbers, they will contact you. Do you want that? I thought not.

13. **The best defense is a good offense.** Unusually large deductions - a big medical expense, a large one-time charity donation, etc. - attract the eyes of the IRS. Instead of waiting for them to question it, attach a disclosure Form 8275 or documentation explaining the deduction. If you are willing to explain and provide documentation up front, then the IRS may be satisfied in which case they are likely to let it go.

14. **Beware of the pitfalls of certain jobs.** The IRS is constantly shifting the industries and areas under which it is focusing its compliance efforts. Those industries get more attention. For example, self-employed persons and those with jobs that traditionally receive cash are much more likely to be audited. You can try to stay up on the IRS, OR you can keep a close eye on your information and receipts, which you will find infinitely easier.

15. **Make timely and accurate estimated tax payments.** If you are going to owe money, then file and pay your quarterly estimated tax payments. Neglecting to make payments or underestimating the amount you owe may garner a penalty and will attract IRS attention.

16. **Bring in a pro.** Don’t take tax advice from your best friend’s brother, your mailman, your barber or your dog. Hire an accountant or a professional tax person. Professionals know the rules, and as an added benefit prepare neat and organized tax returns in a timely fashion.

17. **Try electronic filing.** More than half of all tax returns are now filed electronically and that number is growing significantly. Electronic filing decreases the IRS’s statistical probability of an audit because there are more electronic filers in the pool and, thus, your chances of an audit decrease.

18. **Sign your return.** If you are not going to e-file, then at least sign your return. Come on! No signature = an incomplete tax return = IRS attention.

When preparing your taxes, make sure that everything on your return can be substantiated by some legitimate documentation, like a receipt. If you are audited, good records are crucial and a good paper trail is the best defense. Organize your receipts in some fashion in one place, even a shoebox. When it is time to prepare your taxes, all of your records in one place! After your tax return is prepared, put it with your receipts and keep it. How long? Look for that in another article.

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