

## Avoid the IRS by Knowing the Latest Audit Targets



### IRS Gears Up for More Examinations

The federal government estimates that there's about \$350 billion in taxes missing from its coffers. This so-called "tax gap" represents the difference in the amount of taxes actually collected and the amount believed to

be due. It's the job of the IRS to shrink the tax gap to a reasonable level.



#### International Dealings? Get Ready for More Scrutiny

Multinational corporations and individuals with international dealings should get ready for more scrutiny from the IRS. The Obama Administration has proposed several provisions to crack down on offshore tax avoidance and evasion, including through transfer pricing and transactions through financial institutions.

As part of President Obama's budget, the IRS would be provided funds to hire nearly 800 new employees devoted specifically to international enforcement.

The IRS has a voluntary disclosure program to encourage individuals and companies evading U. S. taxes in offshore accounts to come forward in

exchange for lower penalties and possibly avoiding criminal prosecution. Your tax adviser can help determine if this is appropriate in your situation.



### Key Audit Statistics

In recent testimony before Congress, IRS Commissioner Douglas Shulman noted that tougher scrutiny of taxpayers is already underway.

Here are some of the key statistics:

- In fiscal year 2008, the IRS conducted nearly 1.4 million examinations of individual tax returns (an 8 percent increase over 2006). This reflects a steady and sustained growth over the past three years. Similarly, the audit coverage rate has risen from 0.58 percent in 2001 to 1.01 percent in 2008.
- Although growth in examinations of individual returns is visible in all income categories, it is most apparent in examinations of individuals with incomes of more than \$200,000. Audits of these individuals increased from 105,549 in 2007 to 130,751 during 2008 (an increase of 24 percent).
- In the business area, audit coverage rates for small corporation returns (assets under \$10 million) increased slightly in 2008 over the previous year by .03 percent. Audits of tax-exempt organizations also increased slightly.
- Coverage rates for three classes of large corporations with assets between \$50 million and \$250 million and higher all increased. The coverage rates for partnership returns stayed even as compared to 2007, while Subchapter S returns reflected a small .05 percent drop due largely to the increase in number of S

To further this purpose, the IRS is cranking up its audit machinery again. It's a simple matter of dollars and cents. According to IRS estimates, every additional dollar invested in enforcement in recent years has yielded about four dollars in added tax revenues.

Of course, the IRS intends to go after people who don't file tax returns, as well as those who don't report all of their income.

corporations.

But the IRS is also focusing on taxpayers who underpay their bills by taking deductions, credits and exemptions they are not entitled to or overstating them.

Be aware of the following areas the IRS is pinpointing for close investigation.

**Itemized deductions:** If your itemized tax deductions exceed the ranges established by the IRS for your income group, the odds of being audited go up dramatically. This doesn't mean you should bypass valid deductions, but be prepared to support amounts exceeding the normal bounds. The IRS won't reveal its criteria for determining when deductions are considered excessive, but average deductions are indicated by the IRS "Data Book" published each year. We can provide more details upon request.

**Research credits:** Business taxpayers aren't immune to examination. The IRS recently announced that it will begin scrutinizing refunds for the research credit after examiners found improper documentation and invalid assumptions on many claims for 2008. In certain abusive cases, auditors have been instructed to add a 20 percent penalty on top of the taxable income owed.

**Investment income:** The IRS often discovers unreported taxable income when its computers compare the income reported on tax returns with the information obtained from financial institutions. For example, the IRS electronically matches tax return entries for capital gains and losses, dividends and interest with tax information furnished by banks, brokerage firms and other payors. If your numbers don't "match up," you should address the inconsistencies promptly.

*Changes Ahead:* Be aware that the IRS will soon receive more information about investors' activities.

Right now, the IRS is informed about how much investors sell securities for, but the tax agency relies on investors to provide the purchase prices.

Changes included in a law passed last year will eventually require securities brokers to calculate gains and losses and classify them as short-term or long-term. This information will then be reported to customers and the IRS.

The expanded reporting requirements will apply for specified securities acquired on or after dates beginning in 2011. They were passed in response to tax officials' long-standing suspicion that many taxpayers overstate their tax basis when they sell securities in order to pay less tax.

**Self-employment income:** The tax system makes it easier for self-employed individuals to underreport income and fabricate or overstate their deductions. Thus, the IRS is ratcheting up its efforts to ensure that self-employed taxpayers comply with the law. Those who handle a large amount of cash are under additional scrutiny. (Similarly, the agency is looking at individuals like waiters and waitresses who are often paid tips

in cash.)

To help auditors determine what to look for, the IRS publishes manuals for dozens of businesses, including those comprised mainly of self-employed taxpayers. These audit manuals are available online at the IRS Web site.

**Home office tax deductions:** The IRS has long been suspicious of home office deductions. As a general rule, the office must be your principal place of business or a place where you regularly meet with clients or patients. Again, don't pass up legitimate deductions, but make sure you can substantiate claims.

**Alimony expenses:** After years of perceived abuse in this area, the IRS now matches tax deductions for alimony payments by a former spouse with the taxable alimony income reported by the other spouse. As a result, this has become a prime audit target.

**Automobile expenses:** Traditionally, this a high-risk area for business taxpayers, so it's important to keep detailed records. Auditors are suspicious of claims that a personal car is mostly or exclusively used for business. Maintain a daily log of business mileage with odometer readings as well as the date of business meetings, locations, the business purpose and the names of clients and the nature of relationships.

As you can see, the IRS is casting a wider net as it seeks to close the tax gap. Consult with your tax adviser if you have questions or concerns about your personal situation.

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