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Audits
To Know One is to Avoid One

The best way to handle a tax audit from Uncle Sam is to avoid one from the start.

Regardless of whether you win your battle with the IRS, audits are stressful and a waste of good business time. With audit rates on the rise, it is worth taking a few moments to learn how best to avoid them. Here are some key ways to reduce your chances of receiving an audit notification from the IRS.

HIGH RISK AREAS

Upper Incomes
In March of 2005, former IRS Commissioner Charles O. Rossotti was quoted in the New York Times as saying, "The fact is, people who make more than $100,000 pay more than 60% of the taxes, and we need to focus there." Think of it this way, $100 disallowed to a taxpayer in the 35% bracket generates $35 in additional tax as opposed to only $10 in additional tax generated by someone in the 10% bracket.

Over the past several years, the IRS has been redeploying its resources to focus more heavily on business owners, those with investments and partnerships, and those in high-income brackets.

If you make more than $150,000 a year, your risk and probability of an audit has increased. This means that it has become more important than ever to keep adequate records that substantiate your deductions.

Unreported Income
Unreported taxable income is a common red flag. The IRS discovers unreported taxable income when the taxable income you report on your tax return does not match with information gathered from banks and other sources. If you failed to report interest earned on your bank savings account, the IRS typically will catch this error when it matches the bank's interest payment records, called 1099 forms, against your tax return. Make sure you have 1099s from mutual funds, banks and other income sources.

Self-Employed and Cash Incomes
Past audit evidence shows that self-employed individuals under-report taxable income and abuse tax deductions more than any other group. For that reason, the self-employed are audited by the IRS far more frequently than employees on a company’s payroll. The same holds true for individuals who traditionally receive payment in cash (i.e., taxicab drivers, waiters and waitresses). At times, the IRS will conduct tests to determine whether the taxable income reported by an individual is adequate to support his or her lifestyle.

Lifestyle

Unless you are prepared to defend them, don't take tax deductions that may be questionable. The key words are "reasonable and relative" in relation to income. If you earn $165,000 and claim $125,000 in deductions; or live in Beverly Hills, and report only $30,000 income, don't be surprised if the IRS requests a meeting.

Mileage Logs

Tax deductions for business transportation are some of the IRS's favorite items to audit. This applies to individuals with their own businesses, as well as company employees who use their car, or vehicle, for work. For all business transportation deductions it is important to keep good records of all tax deductible automobile expenses and a detailed mileage log showing business miles driven.

If applicable, mileage logs should be kept on a daily basis, and show the date, beginning and ending odometer readings, the location, business purpose and customer name. While such detail may seem overly demanding for someone with a busy schedule, it will be essential in the event you are audited. Let today's advanced technology aid you. Use your PDA and Outlook calendar to record mileage. Or, consider purchasing electronic automobile products with features for maintaining this information. It will make record-keeping far less time-consuming.

Your Business Expenses must be Business Expenses

Avoid schemes that claim you can convert personal expenses into allowable business expenses just by labeling them as business expenses. If you are "in business," and have a "profit objective" you can substantiate, then the conversion potential is legal. But, you really have to be "in business."

Home Offices

Home office tax deductions are scrutinized by the IRS. Since the tax rules for deducting home office expenses on your tax return are complicated, make sure you qualify for these deductions. By claiming the home office deduction, you increase your chances for an IRS audit. If, however, you are clearly entitled to claim these deductions, you should take them, but only if they are substantial enough to make a tax difference. If the tax savings will be minimal, it is best to avoid claiming home office tax deductions.

Schemes

Be skeptical of secret vehicles or structures that can insulate your income from tax. Time and time again U.S courts have rejected such claims. Just by making frivolous return arguments in tax court, you could be hit with a penalty of as much as $25,000.

STRATEGY CONSIDERATIONS

IRS DIF Score

When your tax return is filed, the IRS computers compare it against what is known as a *differential* score, or the national Discriminate Information Function (DIF) system average. The DIF score is calculated using a closely-guarded formula. Initially, your business is assigned a business activity code. Your tax return will be compared to the national averages for that code. Each line on your return is assigned a score that is then compared to the averages for that code. Tax returns with the highest DIF scores represent returns with the highest probability rates of inaccuracy, and are, therefore, scrutinized by experienced IRS examining officers who determine which tax returns will provide the best opportunity for collecting additional taxes, interest, and penalties.

IRS Audit Calendar

The IRS groups tax returns by zip code and then determines which areas have the highest DIF averages. In July of each year, the IRS assigns its workloads and workforce to those zip codes. Half of all audits are selected randomly, while the other half are based on these scores.

Audits are unpleasant and can even be costly. While large deductions can trigger an audit, you have the right to take all legitimate ones. If you are audited and can provide proof that you have taken only those deductions for which you are eligible and have kept documentation to substantiate those deductions, it is likely that you will be able to adequately answer all IRS auditing questions.

Accountability Services is a full-service accounting, tax and consulting firm that caters to family and privately owned companies. The firm was founded in 1997 in Seattle, WA.