

Gauging your audit risk

Here's what you need to know if your tax return draws attention from the IRS.

First, the good news: The odds are in your favor that the IRS won't audit your federal income tax return. But the not-so-good news is that audits are on the rise. In 2009 the agency audited more than twice the number of returns it did in 2000.

High-income taxpayers are the most likely to face scrutiny. Individual taxpayers with income up to \$200,000 had a 1 percent audit risk in 2009, those with income over \$200,000 had a 3 percent risk, and those earning over \$1 million faced a 6 percent audit risk. What's more, the IRS is increasing the attention it pays to high-income taxpayers. From 2008 to 2009, audits of returns in the \$200,000 to \$1 million range increased by 11 percent while audits of returns showing even higher incomes rose by 30 percent.

Besides high income, certain types of tax returns are looked at closely. Sole proprietors reporting business income on Schedule C are prime audit targets; the IRS thinks they have significant opportunities to deduct personal expenses. Other audit candidates include owners of small companies and taxpayers with offshore accounts.

"The more complex your tax return, the greater the chance it will attract the attention of someone at the IRS," says Alan Olsen, managing partner at Greenstein Rogoff Olsen & Co., a CPA firm in the San Francisco Bay area. "And increased attention raises your audit risk."

MATCH THE NUMBERS

Does this mean that taxpayers with modest incomes and straightforward tax returns are immune to audits? Not necessarily. Even at a 1 percent rate, more than a million of them will hear from the IRS.

You can reduce your risk of audit by making sure that the numbers on your return match the information reports the IRS receives from employers and financial firms. "Be sure to accurately report all interest and dividend income from banks,

brokers, fund companies, etc.," Olsen says. "The same goes for mortgage interest you're deducting." The IRS says it might take a closer look at taxpayers who report extremely large mortgage interest deductions in relation to their reported income.

If you're an independent contractor, you receive 1099 forms each year from the entities you've worked for. Make sure that the gross business income you report is at least as much as the total reported on your 1099s.

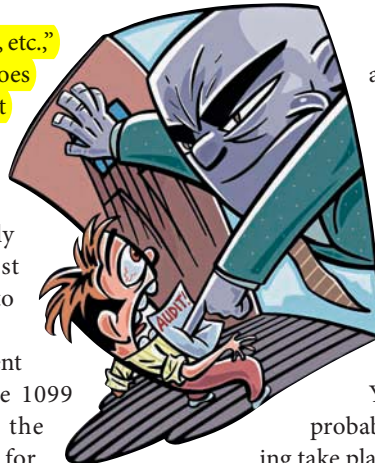
In general, the best way to avoid an audit is to keep a low profile. Don't submit a sloppy, handwritten tax return with arithmetic errors. If you don't hire a tax preparer, use a tax-prep software program that produces a legible return.

ACTION PLAN

What should you do if, despite your best efforts, the IRS sends you an audit notice? Read the letter carefully. Many audits simply ask you to provide documentation for a particular item on your tax return. If that's the case, make copies of the documents in question and send them in. Keep your originals. "If you have a tax preparer, consult with him or her prior to sending any information to the IRS," says David Moise, a partner at Weiser LLP, an accounting firm in New York.

DID YOU KNOW?

Audits don't always result in a bill for additional taxes. In fiscal 2009, 12 percent of all individual tax returns selected for a correspondence audit had no change in taxes due; 11 percent of field audits (those conducted by IRS agents, officers, and examiners) resulted in no more taxes, according to the IRS.



If your IRS letter requests a meeting, your situation may be more serious. Contact a professional adviser—a tax attorney, a CPA, or an enrolled agent who is qualified to represent taxpayers before the IRS—and let him or her arrange the time and place of the meeting.

Your representative will probably request that the meeting take place at his or her office or at the local IRS office.

HOME-OFFICE RISKS

Meeting at your business or your home can be a bad idea, especially if the agent can see a lifestyle that's not in keeping with the income you report (even if that lifestyle is financed by nontaxable income such as family gifts and bequests). Wherever you meet, your best strategy is to provide copies of any requested documents, and answer questions briefly and honestly. Avoid making any unsolicited comments.

If you filed Form 8829, taking deductions for a home office, the IRS examiner might ask to visit your home in order to verify your claim. Be aware that he or she will take note of anything that might indicate your office is used for nonbusiness activities. In fact, you might want to avoid taking the home-office deduction altogether because it may increase the likelihood of an audit.

For any type of audit, be wary of documents the IRS examiner asks you to sign. They might allow the agency to extend the statute of limitations for examining your tax return. You probably should ask for time to discuss the matter with your tax adviser. Better yet, have your tax pro accompany you to any meeting with an auditor. Before you sign anything, get an informed opinion about what the IRS can do if you refuse. \$