Do You Fear an IRS Audit?

When you file your tax return every year, is one of the thoughts at the back of your mind - will I be audited? Many taxpayers fear an IRS audit. The odds are low that your tax return will be selected for an IRS audit. The IRS does not have sufficient personnel and resources to examine every tax return, so the IRS selects those tax returns that, upon preliminary inspection, have high audit potential - those that are most likely to result in a substantial tax deficiency. In recent years, less than 2% of all individual income tax returns have been audited.

IRS Audit Statistics[1]
(Based on Tax Year 1997)

Income for Tax Returns	Tax Returns Filed	Tax Returns Examined	Percent Examined
Less than $25,000	59,211,700	1,076,945	.81%
$25,000 - $50,000	27,263,000	259,794	.58%
$50,000 - $100,000	17,019,200	196,582	.62%
Greater than $100,000	4,540,800	129,320	1.66%

Most tax returns singled out by the IRS for audit contain either tax deductions that appear to be too high in relationship to the person's income, tax items that are erroneous, tax items that require proof or an explanation, or are on the IRS' list of hot tax issues. It is important that the IRS audits tax returns effectively; the IRS puts a general fear of being audited in all taxpayers to encourage voluntary compliance with the income tax laws - the U.S. tax system depends on voluntary compliance. With today's computers there are now more ways than ever that the IRS can monitor your tax compliance. However, your chances for an IRS audit are higher depending upon certain types of income, certain amounts of income, your profession, the types of transactions and the types of tax deductions claimed on your tax return.

Your chances of being audited by the IRS are greater under the following circumstances:

§ You have large amounts of itemized deductions on your tax return that exceed IRS targets.
§ You have complex tax transactions without explanations on your tax return.
§ You have complex investment or business expenses on your tax return.
§ You claim large cash contributions to charities in relation to your income on your tax return.
§ You claim tax shelter investment losses on your tax return.
§ You have rental expenses on your tax return.
§ You own or work in a business that receives cash and/or tips in the ordinary course of business.
§ You are a shareholder or partner in an audited partnership or corporation.
§ Your business expenses are large in relation to your income on your tax return.
§ A prior IRS audit resulted in a tax deficiency.
§ An informant has given information to the IRS.

You must report all your income and you should take all your tax deductions, even if they increase your chances for an IRS audit; don't be scared off by these factors. When you are completing your tax return and you are listing your deductions, you should be aware that your chances for an audit increase if your tax deductions exceed the averages for your income level.

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[1] Source for this information: www.webtax.com

A large number of itemized deductions could be considered "excessive" by the IRS, which could trigger an audit. NOTE: the IRS does not have a description for the criteria it uses to identify excessive itemized deductions. You should take all valid tax deductions on your tax return, but you should also maintain the supporting documentation for them.

Between 1-to-2% of all individual tax returns filed in any year will be selected for audit. Higher-income taxpayers and those in target categories face a slightly higher audit risk than lower-income taxpayers.

Your return may be examined for a variety of reasons. Your return may be selected for examination on the basis of computer scoring. A computer program called the Discriminant Inventory Function System (DIF)[2] assigns a numeric score to each individual and some corporate tax returns after they have been processed. If your return is selected because of a high score under the DIF system, the potential is high that an examination of your return will result in a change to your income tax liability. Your return may also be selected for examination on the basis of information received from third-party documentation, such as Forms 1099 and W-2, that does not match the information reported on your return. Or, your return may be selected to address both the questionable treatment of an item and to study the behavior of similar taxpayers (a market segment) in handling a tax issue.

In addition, your return may be selected as a result of information received from other sources or inaccurate filing. This information can come from a number of sources, including newspapers, public records, and individuals. The information is evaluated for reliability and accuracy before it is used as the basis of an examination or investigation.

IRS audits are conducted in several ways. Some examinations are handled entirely by mail. Examinations not handled by mail can take place in your home, your place of business, an Internal Revenue office, or the office of your attorney, accountant, or enrolled agent. If the time, place, or method is not convenient for you, the examiner will try to work out something more suitable. However, the IRS makes the final determination of when, where, and how the examination will take place.

After the examination, if any changes to your tax are proposed, you can either agree with those changes and pay any additional tax you may owe (occasionally, there is an additional refund amount), or you can disagree with the changes and appeal the decision.

The best defense in an audit is a two-part strategy:

§ Have supporting documentation for all deductions and credits, and
§ See your accountant immediately upon notification that you're being audited.

A professional can put your mind at ease, find the information that the IRS wants more quickly than you can, and very likely will save you money in the long run by getting a faster and more favorable conclusion to the audit.

[2] Source for this information: www.irs.gov/publications/p556