

Dow Jones Reprints: This copy is for your personal, non-commercial use only. To order presentation-ready copies for distribution to your colleagues, clients or customers, use the Order Reprints tool at the bottom of any article or visit www.djreprints.com

See a sample reprint in PDF format.

Order a reprint of this article now

THE WALL STREET JOURNAL

WSJ.com

TAX REPORT | JANUARY 14, 2009

Tips for Dodging an Audit

By TOM HERMAN

The Internal Revenue Service is auditing more upper-income Americans even as the agency has trimmed its overall audit rate.

IRS agents examined 1.01% of all individual income-tax returns last year, down slightly from 1.03% the prior year, officials said. This decline came after five consecutive annual increases, as the agency responded to congressional pressure to crack down harder on tax dodgers.

But at the same time, tax collectors have greatly intensified their scrutiny of upper-income Americans, especially those making \$200,000 or more. In the year ended Sept. 30, the IRS audited 130,751 returns of people in this group. That was up 16% from the prior year -- and up 49% from 2006.

Looking ahead, the overall audit rate this year is likely to remain about the same as last year, says Linda Stiff, IRS deputy commissioner for services and enforcement. But officials are likely to continue their emphasis on high-income taxpayers. Your chances of getting audited are especially high if you work for yourself, file what's known as a Schedule C form for sole proprietors and deal in large amounts of cash. IRS research has shown especially large amounts of noncompliance among this group.

"Like Willie Sutton said about banks, the IRS is looking at high-income, self-employed Schedule C filers because that's where the money is," says Martin Laffer, a certified public accountant at Laffer & Gottlieb in Beverly Hills, Calif. For example, he says one of his clients being audited owns several retail stores and also is a consultant. In such cases, as with so many other audits, tax advisers say it really pays for taxpayers to be compulsive about record keeping. IRS auditors also are turning up the heat on Americans suspected of hiding taxable income abroad.

Many mundane factors can also trigger an audit. Among them: You've claimed unusually high deductions in relation to your income. (The IRS uses a computerized system to score returns based on the likelihood of inaccuracies.) Or the numbers on your return don't match what the IRS received separately from your employer or a financial institution. Or the IRS got a tip from an ex-business partner, ex-spouse or neighbor claiming you're cheating. Or you've invested in what the government considers an abusive tax shelter.

Another possibility: The IRS may suspect you've deducted hefty losses from a side venture that's really a hobby, rather than a true business designed to make a profit. In one recent Tax Court case, the court rejected a Tennessee man's attempt to deduct tournament fishing expenses. The court said the record "contains insufficient evidence" to support the finding that the taxpayer was in this business with the primary objective of making a profit.

Officials also have said they're probing returns of numerous foreign athletes and foreign entertainers who spend time in the U.S. and receive large amounts of what the IRS considers to be taxable U.S. income -- such as payment for endorsements.

Several factors contributed to the unusual audit-rate decline in fiscal 2008, Ms. Stiff says. For one thing, the IRS now has fewer auditors. The number of revenue agents shrank to 12,599 as of Sept. 30,

from 12,816 in 2007 and more than 14,600 in 1997, a spokesman says.

Another factor: On top of handling the usual tax-filing-season madness last year, the IRS had to handle the gargantuan task of distributing economic-stimulus payments to taxpayers. "In addition to doing everything we normally do, we had folks in numerous areas pulled off" from their regular jobs to help with various aspects of the stimulus-payments program, Ms. Stiff says. "We had to make some adjustments" among auditors.

Ms. Stiff says auditors also are spending more time on big-dollar cases that typically involve greater degrees of complexity -- and that require far more time to dispose of than average tax battles involving much smaller sums.

Of course, the overall audit-rate decline is of little comfort to those whose returns do get selected. "Audits can be complex, time-consuming and expensive," says Jackie Perlman of H&R Block Inc. Whatever the case, don't take the ostrich approach and ignore IRS notices. "The longer taxpayers wait, the more penalties may add up," Ms. Perlman says.

In some cases, taxpayers who get audited wind up owing little or nothing -- or they may even come out ahead. Mr. Laffer says a relative of his was audited, and it took him about four to five hours of research, plus meeting with the auditor in his office. The result: The relative wound up getting a refund of about \$35. Ordinarily, Mr. Laffer, says, his fee would have been about \$2,500. Instead, the relative treated him to "a good dinner."

Other IRS data released recently show:

The total number of individual income-tax audits rose slightly last year to 1,391,581, from 1,384,563 the prior year. The audit rate -- returns audited during the fiscal year as a percentage of those filed in the prior calendar year -- fell slightly as more returns were filed.

The total number of audits is still lower than in the late 1990s. More than 1.5 million individual income-tax returns were audited during fiscal 1997.

Most audits now are done by mail, rather than in face-to-face meetings with IRS personnel. About 1.1 million of the 1.4 million audits last year were "correspondence" audits. For 1997, the IRS reported 803,628 correspondence audits and 715,615 in-person audits.

Audits of returns of taxpayers with incomes of \$1 million and higher fell to 21,874 in fiscal 2008 from 23,200 the prior year. But that was up sharply from 14,187 in 2006. The IRS says it audited about 5.6% of returns in this category last year.

Enforcement revenue collected in fiscal 2008 fell to \$56.4 billion from \$59.2 billion the prior year. That was the first drop since the late 1990s (although the figure was the same -- \$33.8 billion -- in both fiscal 2000 and 2001). These figures include revenue not only from audits, but also from collections and document-matching activities.

* * *

BRIEFS: Clarissa C. Potter, IRS deputy chief counsel (technical), has been named the acting chief counsel. Don Korb, formerly the chief counsel, left recently to join the Sullivan & Cromwell law firm. ... A handy IRS guide for individual taxpayers, known as Publication 17, has been posted on the agency's Web site (www.irs.gov). To find it, type "17" in the search box in the upper right-hand corner.

■ **Email:** taxreport@wsj.com.

Write to Tom Herman at tom.herman@wsj.com

Copyright 2008 Dow Jones & Company, Inc. All Rights Reserved
This copy is for your personal, non-commercial use only. Distribution and use of this material are governed by our Subscriber Agreement and by copyright law. For non-personal use or to order multiple copies, please contact Dow Jones Reprints at 1-800-843-0008 or visit www.djreprints.com