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IRS AUDITS

What every taxpayer should know

Mention "IRS audit" and most people envision a steely-eyed agent in a stuffy room questioning everything on their return. In reality, there are five types of audits:

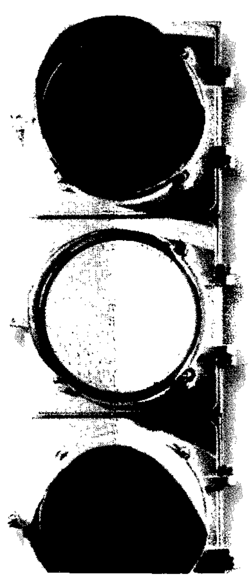
Correction letter. Least threatening is the correction letter. Not a true audit, the correction letter highlights apparent mathematical errors or other discrepancies on your return. Most common are the inconsistencies found by the IRS "matching" program, where the IRS cross checks income reported by payers on Form 1099 (interest, dividends, etc.) with income reported on your return.

Correspondence audit. The next level is the correspondence audit. Similar to the correction letter, this type of audit requests verification of items reported on your return. Usually the IRS will request documentation to support a particular item on your return. This type of audit is usually easy to resolve by mail.

Office interview. The office interview usually indicates that the IRS has a more serious concern about your return. You or your representative meets with the agent at the IRS office. The agent can review any aspect of your return, but usually focuses on a specific area – capital gains, deductions, or the like.

Field audit. The field audit is usually associated with business audits. Here the auditor comes to you and may examine all income and deduction items.

Random audit. From time to time, the IRS conducts random audits to measure how well taxpayers are complying with the tax law. Agents use various audit techniques, including the line-by-line audit where an auditor checks every item on a return. The Service uses the results of these special audits to decide where to focus its regular audit efforts.



Your odds of being selected

Only a small percentage of all the individual returns filed each year will be audited. However, the higher your income, the greater your chances of an audit.

One tool used by the IRS in selecting returns to audit is the Discriminate Income Function (DIF). Each return is scored by the DIF for audit potential. Income is compared to deductions and "red flag" items are noted (for example, tax shelters, home office deductions, etc.).

Absent fraud or substantial understatement of income, the IRS generally has three years from the due date of your return to initiate an audit.

Typically, most returns are selected within two years of their filing date. As you might guess, many things are forgotten over two years. Consequently, when preparing your return, it pays to document and support the items on it.

Higher risk areas

Your chances of being audited are higher than normal if you fall into certain categories or report certain things on your tax return. Some of the higher risk items and areas include:

- Claiming tax shelter write-offs.
- Reporting passive income or losses.
- Making tax protest statements on your return.
- Working in occupations that produce cash income (such as taxi drivers or waiters).
- Being self-employed.
- Reporting related-party transactions (such as paying wages to children or claiming a bad debt deduction for money lent to relatives).
- Earning a high income.
- Having a complex return and preparing it yourself instead of using a professional preparer.

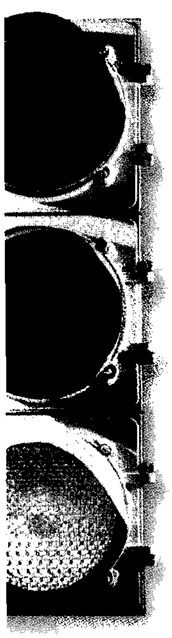
- Using a return preparer who is on the IRS's problem preparer list.
- Taking deductions where the IRS feels taxpayers tend to stretch the truth (such as home office, travel, and entertainment deductions).

In auditing returns, the IRS isn't necessarily limited to a single year's return. The Service uses computers to help identify for audit those returns that are most likely to produce additional tax revenue.

When there is reasonable cause to suspect unreported income, the IRS may ask the taxpayer to explain the discrepancies between reported income and the taxpayer's lifestyle.

No need for alarm

It's wise to contact your accountant when you receive an audit notice. Experienced accountants know how to respond to audit requests.



Many IRS audit notices are incorrect. Yet, taxpayers often meekly pay additional taxes being assessed, assuming the IRS is right or fearing a full-blown audit if they question a notice. Your accountant can review an IRS notice for propriety and decide if his or her services are required, or if you can easily handle the matter yourself.

Don't let fear of an audit keep you from taking legitimate deductions on your return. Just remember, as long as you have written documentation to support items on your return, you will be prepared to face any IRS challenge.

Contact our office if you would like details or assistance with any of your tax concerns. We're here to help you.