The Latest IRS Audit Figures

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"All the taxes paid over a lifetime by the average American are spent by the government in less than a second."

Here They Are!

The latest available (fiscal 2006) IRS audit percentages have been released. About 133 million individual income tax returns were filed — and almost 1.3 million individuals were audited (1%).

As always, it's much more meaningful to dig into the details of various *categories* of income tax returns — and see how they are audited. As always, the "winners" (really losers) continue to be Schedule C filers (those who are self-employed sole proprietors that file Schedule C as part of their individual income tax returns).

The IRS is highly suspicious of the lowest C category (under $25,000): (a) if net losses are claimed that the IRS can sometimes reclassify as non-deductible "hobby losses"; or (b) if there are "questionable deductions" that are really personal expenses. It's probably their least favorite filing category — and their second highest individual audit category — in which they have considerable success in their examinations.

Individual Returns (*with Schedule* C):

Gross Income	Audit Rate 2006	Audit Rate 2005
Under $25,000	3.8%	3.7%
$25,000-$99,999	2.1%	2.2%
$100,000 and over	3.9%	3.7%

Now compare the preceding audit rates to the following tax *without* Schedule C, and you will see that *not one* of the following are as high as *any* of the preceding — not even close!

Individual Returns (*without* Schedule C):

Gross Income	Audit Rate 2006	Audit Rate 2005
Form 1040A under $25,000	0.5%	0.5%
Form 1040 under $25,000	1.5%	1.5%
$25,000-$49,999	0.6%	0.6%
$50,000-$99,999	0.6%	0.5%
$100,000 and over	1.3%	1.4%

(Note that the following corporation examination figures *do not include* S corporation tax returns. The IRS does not break down S corporation audit categories by total assets, but only provides one figure for all S corporations that are audited. If you can't wait, that overall audit percentage for *all* S corporations is a low 0.4% (repeated later),

No balance sheet returns	0.6%	0.5%

Whenever possible, make every charitable contribution in the form of **appreciated property** that you have held over one year.

Corporations by Total Assets — Balance Sheet Included

(excluding S corporations, as noted above):

Gross Income	Audit Rate 2006	Audit Rate 2005
Under $250,000	0.7%	0.7%
$250,000-$999,999	1.0%	1.0%
$1,000,000-$4,999,999	1.2%	1.0%
$5,000,000-$9,999,999	3.4%	2.7%
$10,000,000-$49,999,999	14.2%	12.3%
$50,000,000-$99,999,9999	13.8%	16.4%
$100,000,000-$249,999,999	14.0%	17.5%
$250,000,000 or more	35.2%	44.1%

Current IRS regulations do not require that a corporation supply its balance sheet if both total gross receipts *and* total assets are less than $250,000. This results in the above IRS category of "no balance sheet returns."

Audit Rates for Estate Tax Returns by Size of Gross Estate:

Under $5,000,000	7.8%
$5,000,000 or more	23.4%

TAXTIP: You can bet that as the size of the estate increases over $5 million — the audit percentage increases as well. For example, a $40 million return is *far* more likely to be audited than a $5 million return.

Generally Nontaxable Returns — Overall Audit Rates

Partnership Returns	0.4%
S Corporation Returns	0.4%
Gift Tax Returns	0.8%
Tax Exempt Organization Returns	0.008%

TAXTIP: That absurdly low audit percentage for tax exempt organizations may be one reason why they are now finding quite a few terrorist organizations operating under the guise of tax exempt "charities," along with many phony religious organizations where the leaders live like kings — but pay little or no taxes. In actual numbers, the IRS audited only 7,079 tax-exempt organizations, out of a total of about 849,000 of such returns filed. This super-low audit rate of 8/100ths of 1% is consistent from year to year — and is a real loophole.

(Perhaps our CPA firm could qualify as a tax-exempt religious organization — since we pray a lot about IRS audits.)

More on Audits of Schedules C

Within the high audit categories of Schedules C are three sub-categories that, in our opinion, contain a much higher audit level than the stated overall averages, IF:

- They show a net *loss,* with expenses exceeding (the under $25,000) gross income.
- They report *zero* income and, of course, report a net loss after expenses.
- Their return contains *multiple* Schedules C. Two, three, five schedules, etc.

CAUTION: In the first two cases the *magnitude* of the loss is important. A $300 loss might be ignored. A $15,000 loss is a different thing. As an absolute generalized guess, but based on our experience, those three noted above might have an audit frequency of 10% to 20%. Further ideas:

- Make sure the reported gross income on Schedule C equals or exceeds the total of all Forms 1099 that you received. Further, the IRS considers your reported income even more "honest," if it somewhat *exceeds* the totals of the Forms 1099 (since some small income is usually not reported on a Form 1099).

- If the total deductions on your Schedule C are about 50% of the income, or less — that usually appears to be "reasonable" in the audit eyes of the IRS. When the deductions hit about 65% — you are headed for trouble! In between those percentages is the "toss-up" area (they toss all the tax returns up in the air, and the ones that stick to the ceiling, they don't audit).

- If you have some outside self-employment income (fees, commissions, part-time activities, etc.), with *no* offsetting expenses — report it on Line 21, Page 1, Form 1040 as "other income." This legally *avoids* the filing of a Schedule C, which, of course, itself is a *major* audit trigger. NOTE: You still must pay any applicable self-employment tax *and* you still can claim a Keogh, SEP, Solo 401(k) and/or self-employed medical insurance deductions, if applicable.

- Be aware that the IRS is very suspicious if you file a Schedule C and claim only the *standard* (rather than itemized) deductions. Their theory is that in such cases, many of the itemized deductions (interest, taxes, contributions, etc.) are *also* being claimed on your Schedule C — and you are "double dipping."

Changing from a Sole Proprietorship

Operating as a sole proprietorship generally results in unlimited liability and exposes *all* your assets to lawsuits, judgments, etc. Consider incorporation of your Schedule C business (as either a C or S corporation), for liability protection; *and* to substantially lower the statistical chances of an IRS audit; *and* usually for better fringe benefits. This is particularly true for that highest audit category of over $100,000. At this point your are running a true "business" and the many advantages of other forms of business entities become more and more attractive for many reasons.

If you absolutely refuse to give up your Schedule C status, you have nothing to lose by becoming a "one-person Limited Liability Company (LLC)." Talk to your lawyer about this option, as you could shelter some of your assets from your present unlimited liability; and *still* continue to file that Schedule C as always. (CAUTION: We have been told that a single-member LLC affords less protection from personal liability than a multiple-member LLC, but it's better than nothing.) As far as avoiding IRS audits, a partnership is also much better than filing a Schedule C — and frequently it also helps in protecting your assets as well.

The TPI Can Catch You!

The IRS has a very clever technique for selecting tax returns for audit — particularly ones that might otherwise easily escape. It's called their Total Positive Income (TPI) screening technique. **SIMPLIFIED EXAMPLE:** You sold that business you started 25 years ago — for $15 million! Then, you bought a so-called "tax shelter" from a national CPA firm. This (supposedly) created a deductible loss of $14,950,000. ***So***, the two offset each other on your tax return — leaving you with adjusted gross income of $50,000. Not a very likely candidate for audit, one would suppose.

However, along comes the TPI selection technique, which *ignores* all negative numbers (losses, etc.) on your tax return. So your TPI comes out to $15,000,000, and the audit selection process goes "Bingo"! Then, when you are audited, they dig and dig into your supposed "loss" and those who sold it to you, frequently with very adverse results for all concerned.

High-Income Taxpayers

The IRS is sticking to their absurd definition that *all* taxpayers with incomes over $100,000 are "high income" and much more likely to be audited. How about married taxpayers, both working, one spouse earns $85,000 and the other $60,000 — both reported to the IRS on Forms W-2. Their interest and dividend income is also directly reported to the IRS, as is their mortgage interest and securities sales. Wow! What is there left to audit by the IRS? Point being that the *generalization* that likely audits are on *all* those "over $100,000 income" is a misnomer. However, here are some likely (over $100,000) audit candidates:

- Tax returns that contain amounts not readily verifiable by the IRS (many Schedules C; or income not directly reported to the IRS; large expense deductions; etc.).

- Tax returns with huge losses offsetting their other (more "normal") income. (This was typical of the "tax shelters" that were peddled by the national CPA firms and others, now in complete disrepute after the IRS has virtually destroyed them.)

- Tax returns with income *much* higher than $100,000 — the larger the income, the greater the odds.

Phony Emails from the IRS

One of the latest email frauds is the sending of emails *supposedly* from the IRS, and demanding all your personal information for various clever reasons. *The IRS NEVER contacts you by email! NEVER!* The IRS has now established a special email address to send them all such fraudulent email demands you receive. It's: phishing@IRS.gov. If this has happened to you — by all means send all information to this address. You will be doing yourself and others a big favor — and you can just imagine what the IRS will do when they catch them. GO IRS!

As of this writing, the IRS has identified *60 different* email scams involving their agency. One of the latest is an email that tells recipients that they are entitled to a federal tax refund. All they must do is go to a web site to claim their refund. On the fake web site they are asked to provide all kinds of personal and financial information — which the crooks gleefully use to steal their identity in every way possible!

A recent one, received by one of our clients, is a supposed email from: "Internal Revenue Service admin@irs.gov." It says in part: "…we have determined that you are eligible to receive a tax refund of $63.80. Please submit the tax refund request — To access the form for your tax refund, please *click here.*" Of course once you click they ask for all your personal information and if you are sucker enough to provide it — the identity theft begins!

One more time: **THE IRS NEVER CONTACTS YOU BY EMAIL!**

Phony Phone Calls from the IRS

These are usually made to elderly people, preferably ones living alone. They just keep calling until they find such individuals. The story goes like this: "Good News! We have found that you have a $4,850 refund due you from the IRS. We are the IRS experts in collecting refunds like this." Then comes one of two variations: #1"Just give me your Social Security number and date of

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birth to verify who you are. We will then see that your refund is sent to you." #2 "To get this refund for you, please send us a collection fee of $475 to P.O. Box XYZ — and you will receive your refund in three weeks."

The first method and you have identity theft. The second just steals money. And there are lots of variations and combinations.