The Ins and Outs of Audits

According to the *Kiplinger Letter*, random federal tax audits are starting up again in October after a brief hiatus – about 13,000 taxpayers will receive letters. These are the infamous “line” audits, designed to provide a database to be used in designing guidelines for more efficient inspection of returns. Agents will reportedly be looking specifically for hidden or underreported income and exaggerated credits and deductions listed on Schedules C (profit or loss from business) and F (profit or loss from farming).

The government has been focusing for awhile on the increasing number of self-employed individuals. Even if you dodge the bullet for now, it’s always smart to be vigilant against the expensive and stressful possibility of a tax audit. A qualified tax professional can assist you in the preparation of your return to minimize the chances of an audit coming your way.

There are three types of audits:

- *Correspondence audits* happen when the IRS sends a letter asking for clarification on relatively simple items. It’s usually handled and completed through the mail.
- *Office audits* are conducted on the IRS’s turf. You meet with an examiner who wants to see documentation intended to answer their specific questions. It’s wise not to volunteer any other information beyond what they ask.
- *Field audits* are the stuff of TV cop shows. That’s when the IRS comes to your home and starts nosing around to see why that Bentley is sitting in the driveway of someone who reported $28,000 in income last year. These tend to be pretty serious.

There are some obvious no-no’s that shift your return to the audit pile. The following measures won’t guarantee you’ll avoid an audit, but they’re key issues that the IRS focuses on when deciding which returns to target:

Messing up the basics: This is an obvious point, but remember to sign the return, add the Social Security Number and double-check the math. Fill out every applicable line on the return, or better yet, get a tax preparer to do it since professionally prepared returns tend to be easier to read and understand because you’re paying qualified people to get it right. Bottom line -- sloppy returns tend to draw scrutiny.

Rounding can be a problem: Precise numbers suggest precision. It’s always best to show conservatism to the IRS. Round down to cut off the pennies, but rounding up to the next hundred or thousand tends to draw attention.

Note sales of investments carefully: Anytime you sell stocks or bonds, the IRS and the taxpayer receives a 1099 noting the sale price. Your tax professional can go over the proper way these should be noted on your return. Also remember that income items such as interest, dividends and other sources of income are matched with the return from documents that are already on file with the IRS.

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Scores are everywhere: In case you didn't know, the IRS – like the lending industry – assigns you a score. It's called the Discriminate Information Function (DIF), a computer program that compares, among other things, the deductions you're taking against others in your income bracket. It's the way an increasingly technology-driven IRS is screening for suspicious returns. One of the best ways to avoid a high DIF score is to report all income – don't let yourself think that any amount is not worth reporting.

Be wise about itemized deductions: You should claim every deduction the law entitles you to, but a good tax professional can advise you of reasonable limits that are less likely to trip your return. In particular, the IRS looks for overblown charitable deductions – make sure you make cash contributions by check or credit card so there's a record, and just make sure that all your donations have receipts or other acknowledgement from the charity – that's a strict requirement of the Pension Protection Act of 2006.

If you do get audited, you need to prove the original value of the items donated and their fair market value.

Keep scrupulous mileage records: If you use your vehicle for work or business, keep a notebook or chart in the car so you can record mileage information as soon as you complete it. The records should list beginning and ending odometer figures, location and reason for the trip. Keep the same records for mileage claimed for medical expense and charitable purposes.

Watch that home office: Even though the government loosened restrictions on home office deductions in 1999, make sure you can substantiate that business area of your home if you're asked.

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