Tax Audits: Cause for Concern?

For many taxpayers, the words "tax audit" can produce feelings of anxiety. It may put you at ease to know that in fiscal year 2005, the Internal Revenue Service (IRS, 2008) actually audited *less than* 1% of all tax returns.[1] So, why all the concern? Not knowing the factors that can trigger an IRS audit often contributes to high levels of anxiety.

How Random Is the Selection?
The large majority of returns selected for audits are done so by computer. The process compares individual returns to *statistical averages* for similar taxpayers in terms of income, number of dependents, geographic locale, etc. Discrepancies from the "averages" make up a score called the **DIF (Discriminant Function)**. Typically, returns with the highest 10% of DIF scores are chosen for audit reviews.

In addition, certain "discrepancies" are likely to automatically trigger an audit. One such example occurs when the income listed from various sources (e.g., wages, interest, dividends, capital gain transactions) does not match the reporting statements (e.g., W-2, 1099-Int, 1099-B, 1099-R) submitted to the IRS. Another instance likely to lead to an audit is when an item is reported in an incorrect or unusual place on a return.

Moreover, some circumstances may increase the likelihood of an audit. For example, in any given year, it is common for the IRS to target specific professions and/or deductions for special scrutiny. Recently, the IRS has announced that it will increase its enforcement efforts of pass-through entities, such as S corporations, as part of its National Research Program (NRP).

All Audits Are Different
While the purpose of all audits is to verify sources of income and validate deductions, exemptions, and credits, there are three basic types of IRS audits that vary in terms of comprehensiveness.

1. A **correspondence audit** involves a request from the IRS that you mail back proof of a particular item on your return. The IRS also uses this mail-based procedure to make **adjustment audits—**usually tax increases--based on calculations made by IRS computers. If the taxpayer accepts and pays the assessment notice, these audits usually end here. If the taxpayer believes the assessment is incorrect, he or she can challenge the notice by following the appropriate IRS procedures.

2. An **office audit** is a request that you meet with a tax auditor at an IRS office. The notice usually identifies the aspect of your return in question and specifies the proper documentation needed to settle the audit.

3. A **field audit** is usually a little more onerous, involving a meeting at your home or office with an IRS agent. In addition to reviewing supporting documentation for certain items on your return, the agent may be trying to evaluate whether your lifestyle is consistent with your reported income.

Know Your Rights
If you receive an audit notice from the IRS, hiring a tax professional to represent you

may be an appropriate strategy. Should you choose to handle an audit yourself, however, the Taxpayer Bill of Rights (included in the Technical and Miscellaneous Revenue Act of 1988) allows you to tape record your meetings with an auditor, if prior approval has been obtained from the IRS, and to adjourn a meeting with an auditor at any time to either consult with your tax professional or to request professional representation.

The best way to be prepared for the possibility of a tax audit is to keep well-organized records of your prior years' returns along with complete, supporting documentation. Furthermore, while you may find tax theory a less than exciting subject, it is in your own best interest to try to understand as much of your tax return as possible. While these steps may have little effect on your chances of being audited, they will help reduce your *anxiety level* should the IRS request more information about your tax return.

[1] IRS. "Table 10-Examination Coverage: Recommended and Average Recommended Additional Tax After Examination, by Type and Size of Return, Fiscal Year 2005." http://www.irs.gov/pub/irs-soi/05db10ex.xls (accessed May, 2008).

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