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How to Sidestep or Survive Increasing IRS Audits

By Robert W. Wood

As a tax lawyer, I'm not supposed to give advice about audit lotteries or to base my tax advice on statistics that show most tax returns will never be examined. In fact, tax advisers are actually *required* by U.S. Treasury Department rules to assume *every* return will be audited. In truth, however, there might be only a 2 percent chance of audit.

When I tell a client there is a 50/50 chance a tax deduction will be upheld, I mean there is a 50/50 chance assuming it is examined and that the Internal Revenue Service or the courts will have to decide. Because of these strict standards, it can be awkward to talk about audit risk. Yet no matter how sure you are of your return, you don't want to be audited.

Despite the rule that tax advisers must assume returns are audited, there is nothing illegal or unethical about hoping to sail beneath the radar. Like a bar exam, you want to submit your tax papers and have them accepted without any fuss. Given how inconvenient and nerve-wracking any audit can be, it's only natural to worry.

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This is especially true if you have a large income or a complicated tax return. There are many views about what will prevent or trigger an audit. In fact, I sometimes think the subject is better left for witchcraft. If you chew the fat with tax return preparers you'll hear many old wives' tales about what will and will not trigger an audit. Still, the latest IRS statistics are worth a look.

Here is my own list of do's and don't's:

Report each Form 1099 and K-1. This seems obvious, but still trips up many people. All Forms 1099 and K-1 are linked to your Social Security number. Don't ignore them. If you disagree with the amount or nature of a payment, you'll need to explain it. Talk to a professional about the best way to do that on your facts.

If you can, avoid Schedule C. This proprietorship schedule is one of the most likely types of returns (it is really a part of a return) to be examined. It is what you file if you operate a small business that is not in a legal entity (such as a corporation, LLC or partnership). Examples are little enterprises you run from your garage, on the internet, or on weekends, even though the bulk of your income may come from wages from your regular job. Schedule C is also the primary place the IRS can audit "hobby" activities that you claim are a business that the IRS disputes. Be especially wary if you have several years of losses in a row.

Use care with noncash charitable donations. If you make them, scrupulously follow the forms, especially Form 8283, which is linked to appraisal requirements. Don't get too greedy with valuations, and expect scrutiny, especially on large contributions.

Pay S corporation wages. If you own an S corporation, make sure the company pays you a fair wage for what you do. Wages are subject to employment taxes. This is the flip side of the "reasonable compensation" issue for C corporations. With a C corporation, the IRS may criticize you for paying *too much* in compensation on a deductible basis. The IRS may say some payments are nondeductible dividends. With an S corporation it is the reverse.

This issue has come up several times in politics, first with former Sen. John Edwards, and more recently with Newt Gingrich. In each case, the candidate was criticized for having an S corporation he owned paying out small amounts as wages with the lion's share of the earnings distributed as dividends. What was at stake for Edwards and Gingrich was the additional payroll taxes they would have borne had their company paid out the entire amount as salary or bonus.

Edwards had his law corporation pay him a $360,000 salary and a $5 million dividend. For Gingrich, his salary was $444,327 and his dividend was $2.4 million. A dispute of this sort primarily involves what is reasonable compensation for services rendered, and the IRS looks at this issue in earnest.

Beware real estate losses. If you have rental real estate, lose money and offset your losses against other income, expect scrutiny. Keep especially good records of how much time you spend on the real estate activities, since that can influence whether your losses are "active" or "passive."

Avoid excessive travel and entertainment deductions. Even if your income is high, excessive travel and entertainment expenses for business can make you stick out. Consider carefully if you really meet the business purpose tests before you claim them.

Is the number of audits increasing? Yes. The IRS has outdone itself with a banner uptick in audit rates, surging a whopping 34 percent between 2010 and 2011 for those with over $200,000 of income. That's a sizable increase in just one year. Of course, that doesn't mean you will be audited if your income tops this - or any other - level. Audit rates are still comparatively small no matter what your income.

In fact, only 3.9 percent of taxpayers reporting over $200,000 of income were audited in 2011. For taxpayers with more than $1 million of income, 12.5 percent of taxpayers were audited. That was an increase of 24 percent over the prior year. There's an understandable fascination with these figures.

High income means you could stick out from the pile. Nevertheless, even with the recently released figures, it's not the whole story. Big numbers alone don't produce audits. And that's so even if you are very wealthy. The IRS has a special task force to audit the very wealthy.

If you are audited, provide receipts and other supporting information if the IRS asks. Think carefully if you have memos and letters from tax advisers about whether you qualify for a deduction, audit risk or potential tax litigation. You don't want to hand the IRS a roadmap of arguments to make against you. "Work-product" protection means a taxpayer need not turn over documents created in anticipation of litigation. This protection has wide application, not just to tax litigation.

What should you do if the IRS asks for all of your documents about a particular deduction, income item, or tax year? As part of vetting a particular tax position, you and your tax advisers may discuss which tax arguments the IRS could make. You might talk about audit risk and tax authorities pro and con. Traditionally, documents to be used in tax litigation and relating to the strength or weakness of a tax position are covered by work-product privilege so the IRS generally cannot get them.

Work-product protection is different from attorney-client privilege. Attorney-client privilege protects communications between clients and their lawyers, whether or not those communications deal with anticipated litigation. Discussions with tax lawyers are privileged, but discussions with accountants are not, unless the accountants are subcontractors of the tax lawyers. Having lawyers hire accountants can bootstrap attorney-client privilege to accountant communications, which makes sense where tax litigation is imminent or might involve an IRS criminal matter.

This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.