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THE TAX LAWYER

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### What's Your IRS Audit Risk?

**Do You Feel Lucky?** No one wants to be audited. And yet as a [tax lawyer](#) advising clients about tax issues, I'm required by Treasury Department rules to **assume** every return will be audited. In truth, there might be only a [2% chance of audit](#). When I say there's a 50/50 chance a tax deduction will be upheld, I must assume it will be examined.

Because of these [strict standards](#), it can be awkward to talk about audit risk. But understandably, no matter how sure you are of your return, you don't want to be audited. You want your return to look plain vanilla, and nothing prevents you from trying to make it sail through as long as you fully and fairly complete it. See [10 Ways To Audit Proof Your Tax Return](#).

**Audit Witchcraft?** There are many old wives' tales about what does and doesn't trigger an audit, but the latest IRS stats are worth a look. The IRS has pulled back the shroud on audit rates in its [2010 Data Book](#), providing important clues about your chances. The numbers reveal some surprising percentages.

Only about 1.1% of 142,823,105 individual income tax returns were audited in 2010, up slightly from a year ago. Does high income mean you stick out from the pile? Not necessarily. In fact, a whopping 30% of returns audited claimed the earned income tax credit ([EITC](#)). By definition those are lower income returns, not exceeding \$35,535 (\$40,545 married filing jointly) with one qualifying child. See [EITC Income Limits, Maximum Credit Amounts and Tax Law Updates](#).

But rising income generally means rising risk. If you had non-business income of \$200,000 to \$1 million, you had a 2.5% chance of audit, increasing to 2.9% if your return showed business activity. But if your income tops \$1 million, the audit rate was 8.4%, way up from 6.4% in 2009.

For business returns (except farms) showing total gross receipts of \$100,000 to \$200,000, 4.7% of returns were audited. If you exceeded \$200,000 in gross receipts, audit rates dropped to 3.3%. Only 0.4% of returns with farm ([Schedule F](#)) income were audited.

There are also some interesting points about offsetting adjustments and deductions. If your adjusted gross income (AGI) is between \$100,000 and \$200,000, you had a 0.71% chance of audit. It jumps to a 1.92% audit rate for AGI of \$200,000 to \$500,000. The audit rate jumps to 6.67% for AGI between \$1 million and \$5 million.

Business tax returns fared better than individual returns. Only 1.4% of small corporations with total assets of \$250,000 to \$1 million were audited. The rate rose to 1.7% for assets of \$1 to \$5 million, and to 3% for assets of \$5 to \$10 million. Over \$10 million in assets, the audit rate jumped to 16.6%. For partnership and S corporation returns, the audit rate was 0.4%.

**Audit How?** The days of field and office audits are waning. 78.3% of individual audits were just correspondence.

**Reading Tea Leaves.** So what do these IRS stats tell you? Here's one tip. "Business income" on an individual income tax return means a [Schedule C](#). Tax advisers have long known that Schedule C is one of the most likely types of returns (or parts of returns) to be examined. This proprietorship schedule is what you fill out if you have a small business you operate yourself 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 you claim expenses from your little business. That means it's the primary way the IRS can audit "hobby"

activities that you claim are a business but the IRS disputes. If you have \$1,500 of income from your “race car business” and \$138,000 in expenses, it would go on your Schedule C. For more, see [Business or Hobby? Answer Has Implications for Deductions](#).

See also:

[The ABCs of Hobby Losses and Profit Motive](#)

[When Taxpayers Go Fishing For Deductions](#)

[Hobby or Business: IRS Scrutinizes Brothel-Hopping](#)

[10 Tips For Deducting Your ‘Hobby’](#)

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