

When Audits Become Criminal Investigations

By Robert W. Wood

Tax audits are nobody's favorite topic. Sometimes your number just comes up, although there are some things that make that more likely. Let's start with some of those. First is income. The higher your income, the more statistically likely it is that you will be audited.

Still, audit rates are very low. You might have less than a 1 percent chance of audit if you make say \$100,000 to \$500,000. It might go up to around 4 percent if you make \$1 to \$5 million. So, you might skate by forever. Yet it isn't just about income.

Some types of income, issues and returns stick out. Here are just a few that can make your return more likely to be audited. Schedule C is a big one. This is proprietorship income, whether it is your activity as a solo lawyer, income (or loss) from horse breeding, farming or that eBay business you run from your garage.

Small business may be the backbone of America, but the IRS figures that small business activity reported on Schedule C is a goldmine for extra taxes. They are usually right. Losses on Schedule C that offset other income are especially low hanging fruit.

And if you make a profit, don't forget about self-employment tax. For self-employed people, it is the equivalent of both halves of the employment taxes that are taken out of your pay via withholding. Self-employment tax is a whopping 15.3 percent.

What else can prompt audits? Many CPAs cite home office deductions as a prime culprit. There are exceptions, but in most cases, you have to use that part of the home *exclusively* for business, which is tough. Plus, in most cases it has to be a *primary* place of business.

Unreported income is a biggie, and a dangerous one. If you do not report income that the IRS knows about from a Form 1099 or Form K-1, be careful. More broadly, though, do not assume that if you do not receive a tax reporting form, a payment must not be income! Virtually everything is gross income, with few exceptions.

However you end up in an audit, is there anything to fear? It depends. You should always take it seriously, and you should never tell the IRS something that is not true. Bad conduct in an audit can be a bigger and more serious problem than bad tax mistakes.

Do not compound your errors or your aggressive tax planning with aggressive audit conduct. In fact, you are vastly better off if you hire an accountant or tax lawyer (or both) to handle it. What can cause your tax audit to get vastly more serious?

There is no single answer. However, keep in mind that most criminal tax cases come out of plain old civil audits. That fact alone is sobering. If an IRS auditor discovers something suspicious in a civil audit, the auditor can notify the IRS's Criminal Investigation Division. Notably, the IRS is not obligated to tell you that this criminal referral is occurring.

In fact, normally, the civil auditor will suspend the audit without explanation. You might assume that the audit is over, or at least mercifully stalled so that it might not ever resume. Meanwhile, the IRS can be quietly building a criminal case against you. Some of the pressure points are obvious.

For example, one big mistake is omitting income. Whether you receive a Form 1099, W-2, K-1, or no reports at all, report all your income. Discrepancies can trigger audits. Moreover, if omissions of income are significant and do not look to be unintentional, watch out.

Excess or aggressive deductions are less likely to be viewed as seriously, but some of this is a question of degree. This is especially true with items that you try to write off that are clearly personal. In that sense, you may be better off if you can separate your tax life into business and personal.

Many big, messy, and expensive tax disputes come down to trying to morph personal into business to get a write-off. False statements to auditors are an even bigger mistake. Conduct during the audit itself can be pivotal, and is one reason to hire professionals to handle it.

Some of what goes on at the IRS is computer matching — the endless correlation of taxpayer identification numbers and payments. Keeping good records is important. With a six-year IRS statute of limitations in many cases, keeping records for six years after you file is a good idea. Keep copies of your tax returns themselves forever.

Moreover, you may need basis records for decades. Suppose you buy a house and improve it over a 10-year period. Keep the receipts. You'll need them later when you sell it, even if that is in 25 years.

If your case truly goes criminal, be especially careful. Like the FBI, the IRS Criminal Investigation Division uses the "special agent" terminology. If you are visited by an IRS Criminal Investigation Division special agent — even if they say you are not the target — consult with an attorney. You are not legally required to talk to the IRS.

The Fifth Amendment guarantees your right against self-incrimination. You might assume that by answering a few simple questions, it can't hurt — especially if you are just a witness. Don't be so sure. Regardless of how adept you are at communication, speaking up may actually help the IRS build a criminal case against you.

The IRS may (quite honestly) tell you that you are not the target of the investigation, and are only a witness. Even so, it is safest not to talk to them and to retain counsel. You might think that your cooperation will make the IRS appreciate you and leave you alone. Be careful.

The ramifications of getting flustered and running at the mouth can be extreme. Particularly given the fluid nature of who is a witness and who is a target, even statements you think sound innocent may not be. Suppose you are asked whether you do business with Joe or know Sally. If you answer falsely, you may face felony charges. See 18 U.S.C. Section 1001.

Plus, making a false statement can be considered evidence of an attempt to conceal other criminal conduct. If you are approached and questioned by a special agent, ask for his or her business card. Firmly but politely state that you do not want to answer any questions and that you will have your attorney contact the special agent.

Even if you are convinced that you are merely a witness and will remain so, you have the right to assert your constitutional privilege against self-incrimination. See *Bellis v. United States*, 417 U.S. 85 (1974). You can fully cooperate through your attorney.

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