TAX REPORT

Are You Ready to Be Audited?

Here's how to prepare for the questions you hope you never get.

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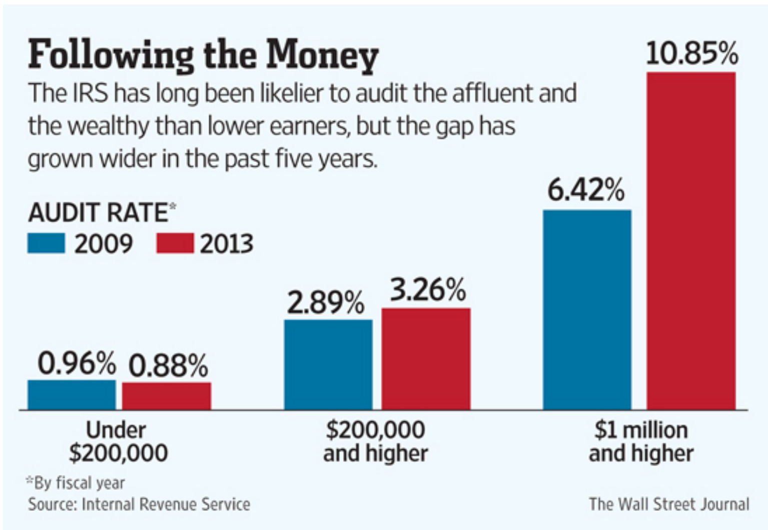

The Internal Revenue Service's most intimidating weapon is the power to audit—and well-heeled taxpayers are more likely to be the target.

Audits are rare and getting rarer as the agency faces funding cuts. Fewer than 1% of taxpayers endured one last year, according to IRS figures. But while the audit rate has fallen over the past five years for taxpayers who earn less than $200,000, the rate has risen for those earning $200,000 to $1 million.

The increase was particularly sharp for people earning $1 million or more. Nearly one in nine of those taxpayers was audited last year compared with fewer than one in 15 in 2009.

"It's as though they'd rather audit 10 high-income people and get something, rather than 25 cash businesses and get nothing" because the owners can't pay, says Janet Hagy, a certified public accountant in Austin, Texas.

Taxpayers facing an audit also are dealing with an agency that is underfunded and often unresponsive. IRS Commissioner John Koskinen recently told Congress the agency won't be able to answer 18 million phone calls this year, nearly 40% of the calls it receives, and that the wait time for those who do get through will be about 25 minutes, up from 10 minutes in 2010. More than half the letters taxpayers send to the IRS this filing season will take longer than 45 days to answer, he added.

Audit Bait

The Dirty Dozen: Moves That Could Trigger IRS Scrutiny

The IRS training budget has dropped 87% since 2010, which is affecting audits of all types, experts say. "In the last few years, I've seen more delays, ill-founded IRS positions and outright bad behavior than ever before," says Andy Biebl, a CPA who oversees tax audits for CliftonLarsonAllen in Minneapolis.

In a statement, the IRS said that "taxpayer rights are a critical part of the federal audit process and the IRS expects all employees to communicate and respect these rights. We are committed to running a fair and balanced audit process."

Taxpayers trying to stay out of the IRS's cross hairs should first understand what can put a bull's-eye on their backs. Reporting a high income can increase the likelihood of an audit, but other items can also invite scrutiny, such as using a tax preparer who has previously run afoul of the IRS or entering suspiciously round numbers on a tax return. (For a list of audit triggers, see page B10.)

One of the main tools the IRS uses to identify potential audit candidates is a computer program that compares individual returns with various norms to find outliers, such as unusually large deductions for charitable donations. The program generates what is known as a DIF score—for "discriminant function"—that can mark a return for closer attention. Taxpayers who want to avoid an audit should be alert to the risk of standing out from the crowd.

In addition, the IRS is zeroing in on certain issues it once ignored that often affect high earners. For example, Mr. Biebl says, the IRS often takes a close look when deep-pocketed taxpayers claim a large loss in one area that offsets big profits in others. The agent then questions whether the loss was deductible for that year or should have been deferred, which lessens its value.

If the IRS does single you out, it is also important to understand that not all inquiries are formal audits. Some are only letters asking routine questions about math errors or data mismatches, while other inquiries—even if they are conducted by mail—can dig deeply into the return.

Be on your guard, however, if a pair of senior agents attends a meeting. Criminal investigations are rare, but if the IRS sends two people, "something very serious could be going on, and it could mean the matter will wind up in court," says Michelle Ferreira, a tax lawyer at Greenberg Traurig in San Francisco. One reason: The agents can corroborate each other's testimony.

Here are other tips for avoiding or surviving an encounter with the IRS.

Keep accurate records.

This is the first commandment of dealing with the IRS, experts say. Make sure all the necessary records are in order before filing your return.

For example, charitable deductions often are fertile audit ground because many taxpayers aren't aware of strict rules requiring documentation of a donation, such as a letter from the charity, before taking a deduction of $250 or more.

Ms. Hagy recently told one client to get such a letter for a $50,000 donation to his church. "He thought his canceled check was proof, but it's not," she says.

IRS agents also consider "contemporaneous records" particularly important. Such records can include logs of miles driven for a charity or notes about business matters discussed at a lunch whose cost a taxpayer is deducting.

In particular, carefully save and check all third-party reports, such as 1099 forms that disclose dividends, retirement-plan payouts and other miscellaneous income to the IRS. Leaving such information off a return will often generate an IRS letter.

If those reports have mistakes, try to have them corrected. If that isn't possible, put the wrong number on the return and then provide the correct information on the same form. If you only show the right number, you also are likely to get a letter from the IRS, Ms. Hagy says.

Experts recommend keeping records for up to six years, except in the case of asset purchases such as a home or stock in a company. Keep those records for six years beyond the last date you own the asset.

Know what you are facing.

The IRS reaches out and touches taxpayers in many ways.

One of the agency's most common challenges is a "math error" letter. Taxpayers ordinarily have 60 days to respond either by paying any additional assessment or disputing the IRS's conclusion. Though the letters aren't considered formal audits, that doesn't mean they are fun to receive—in fact, National Taxpayer Advocate Nina Olson, an IRS ombudsman, has said they are often unclear and subject to processing delays.

The IRS also sends letters when its computers detect income reported by other sources that taxpayers have omitted on their returns, or other discrepancies. In 2012, the IRS sent 4.5 million such letters, which resulted in 15% more income for the government in the most recent fiscal year than five years prior.

Among formal audits, "correspondence audits" are the most common, accounting for 70% of the roughly 1.4 million that took place in fiscal 2013. They are handled by mail, as the name suggests, and tend to focus on a single issue such as charitable deductions or entertainment expenses.

Most other formal audits are "field audits," face-to-face exams that often cover more than one issue. A tax professional can often minimize or prevent direct contact between the agency and the taxpayer that could lead to further problems.

Among the rarest are "research audits," which some professionals call "audits from hell." Taxpayers are chosen randomly and asked not only to verify information on their returns, but also to answer intrusive questions aimed at detecting unreported income. The IRS's goal is to figure out how to catch tax cheats down the road.

Jeffrey Porter, a CPA practicing in Huntington, W.Va, helped a client facing a research audit in which the IRS asked whether the client had a safety deposit box, the names of his banks and "other nitpicky questions." In other research audits, agents have asked to see marriage or birth certificates.

Criminal investigations are also rare but especially risky for the taxpayer. The IRS recommended prosecution in 2,500 tax-related cases last year, and the agency wins more than 90% of the cases that get that far.

Don't panic.

Never lie to the IRS, experts say. "They'll probably sense it and you'll be in even worse trouble," says Jonathan Horn, a CPA practicing in New York.

On the other hand, don't rush to pay whatever the agency asks. Often the IRS is wrong.

For example, a year ago Edwin Ziarko, a retired engineer living near Chicago, received a letter saying he owed an additional $18,000 for 2011 because of a Roth individual retirement account rollover and an annuity payment. With one phone call and one letter, Mr. Ziarko showed that the agency was mistaken, and within three months of the original notice he was told he owed no tax.

Think twice before representing yourself.

While it might be fine to correspond directly with the IRS about a math error or computer mismatch, be careful about going it alone in a formal audit. An experienced professional may be able to save time, trouble and money. Many will take on cases even if they haven't prepared the return.

In particular, Mr. Biebl says, taxpayers should remember that small-dollar issues in one year—such as whether to categorize a loss as capital or ordinary—sometimes turn into big ones in future years.

Are you considering buying audit protection through a mass-market tax preparer? Such plans promise to help if the IRS questions the accuracy of your return. Check carefully for time limits, exclusions and other restrictions, as well as whether other buyers have been satisfied.

Never ignore an IRS letter.

Whenever the agency writes you, respond—even if all you do is send another copy of a letter you sent previously, experts say. Unfortunately, the IRS doesn't accept email from taxpayers.

Experts recommend communicating via certified mail and keeping careful track of the receipts.

Don't forget your state.

If you wind up owing the IRS more money, your state of residence will probably want its due as well. Many have rules requiring taxpayers to inform them within a certain period if the amount of federal tax they owe changes. Most states also have information-sharing agreements with Uncle Sam.

So don't neglect your state obligations—or yet more tax trouble could be in store.

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