

A quarterly newsletter examining recent tax developments for the business professional.

WHAT ARE YOUR CHANCES OF BEING AUDITED?: AN IN-DEPTH LOOK AT AN IMPORTANT QUESTION

The most burning question often asked of tax practitioners is a simple one – “What are my chances of being audited?” Despite the simplicity of the question, the answer is relatively complicated. An individual’s or business’ chance of being selected for an Internal Revenue Service (“IRS”) audit is based on a number of different factors, including IRS computer models, certain “red flags” that may target a return for examination, and the failure to report information that was reported to the IRS by a third party, such as on a Form 1099-INT filed by a bank. Recently, the IRS released its annual “data book,” a publication that provides statistical information regarding the IRS’s audit activities during the previous fiscal year. One key piece of information contained in the recent data book is the number and categories of tax returns examined by the IRS during 2009 – statistics that also help predict the IRS’s likely audit activities during 2010 and beyond.

As noted above, the IRS’s annual “data book” contains statistical information regarding the IRS’s audit activities during the previous fiscal year. In this case, the 2009 data book compares tax returns filed in the 2008 calendar year, and audited during the 2009 fiscal year, to returns filed during the 2007 calendar year and audited during the 2008 fiscal year. Before delving into the 2009 data book statistics, however, some background information about the IRS audit function is helpful.

The IRS derives its audit authority from Section 7602 of the Internal Revenue Code (the “IRC”), which grants the IRS broad authority to “examine any books, papers, records, or other data” relevant to determining the correctness of any federal tax return. In carrying out its examination function, the IRS conducts three main types of audits, namely correspondence audits, office audits, and field audits. The correspondence audit is the most straightforward and involves a letter from the IRS requesting additional information with respect to a particular item on a tax return and/or proposing an additional amount of taxes due.

The next level of audit is the office audit, where the IRS asks that certain information be presented during a meeting with an IRS revenue agent. The third and most complicated type of audit is a field audit. Field audits are conducted by the IRS at the taxpayer’s place of business and are the most comprehensive form of audit conducted by the IRS.

Tax returns typically are selected for examination by the IRS based on a number of factors, the first of which is computer modeling – whereby the IRS assigns “scores” to tax returns based on computer generated

norms. The higher the score or “DIF” (Discriminate Information Function) number assigned to a return, the more likely the return will be audited. In addition, certain “red flags” can draw the IRS’s attention to a particular return and result in an audit. These red flags often include:

1. Participation in, and disclosure of, “tax shelters” and other “listed transactions,” such as the use of offshore trusts;
2. Returns claiming large deductions for travel, entertainment, and automobile expenses;
3. Returns reporting large business losses for several consecutive years;
4. Returns filed without the necessary supporting documentation and/or schedules;
5. Returns reflecting a high ratio of expenses to income;
6. Employment in or by a “cash-paid” business (e.g., returns file by taxicab drivers, hairdressers, and waiters);
7. Subchapter S corporation returns reflecting low shareholder salaries and large distributions;
8. Early IRA withdrawals that are not reflected on a tax return;

9. Returns reflecting large business deductions for payments to independent contractors;
10. Returns reflecting large or numerous non-cash charitable donations;
11. Returns claiming home-office deductions;
12. Returns reporting installment sales; and
13. Returns reflecting large damages or theft loss deductions.

Beyond the above-listed “red-flags,” document matching errors also are common audit trigger. Document matching errors occur when a third-party, such as a bank, brokerage firm, employer, or other payor, files an information return with the IRS, such as a Form 1099 or Form W-2, and the information reported on the taxpayer’s return does not match the information provided by the third-party. These types of errors often result in IRS correspondence audits.

Finally, from time-to-time the IRS also focuses on specific industries or issues for audit. For example, the IRS currently is pursuing audits of business taxpayers with respect to whether they have properly classified independent contractors and employees for employment tax purposes. These coordinated industry and issue type audits are common, with the IRS regularly issuing information regarding new industries and issues of interest.

With this background information in mind, the 2009 IRS data book reveals some interesting information regarding a taxpayer’s statistical chances of being audited and the types of IRS audits being conducted.

Overall, an individual taxpayer’s chances of being audited are relatively small. Of the 138,788,744 individual income tax returns filed in 2008 only 1,425,888, or roughly 1%, were audited by the IRS. The bulk of these audits, approximately 77.1%, were conducted via correspondence audit.

Interestingly, 35.64% of the individual audits were conducted with respect to returns reporting an earned income tax credit (“EITC”), which is a federal tax credit available to the working poor. On the other end of the spectrum, of individual returns showing income of \$200,000 to \$1 million, 2.3% were audited, and, of individual returns showing income of \$1 million or more, 5.6% percent were audited. The conclusion - the likelihood of an IRS examination goes up as income

levels go up and the chances of being audited are disproportionately high for persons claiming the EITC.

With respect to business audits, the 2009 data book similarly reveals that the overall chances of being audited are small. Of all corporate income tax returns (not including returns filed by S corporations) filed in 2008, approximately 1.3% were audited. For small corporations with total assets of (i) \$250,000 to \$1 million, 1.3% were audited; (ii) \$1 to \$5 million, 1.8% were audited; and (iii) \$5 to \$10 million, 2.7% were audited. For very large corporations, those with total assets in excess of \$10 million, the overall audit rate was 14.5%. As with individuals, the likelihood of a corporate audit increases as total corporate assets/income increases.

Finally, the overall audit rate for partnership and Subchapter S corporation returns was, in comparison, extremely low, only 0.4%. It may, therefore, not be surprising that the 2009 data book also reflected an increase in the number of partnership and S corporation returns filed.

In addition to data regarding the overall audit rates, the 2009 data book also provides information regarding the number and types of civil and criminal penalties imposed by the IRS during the 2009 fiscal year. According to the 2009 data book, the IRS assessed 26.387 million civil penalties against individual taxpayers during 2009. Of these, the three main penalties imposed were the failure to pay penalty (54.71%), the underpayment of estimated tax penalty (28.67%), and the delinquency penalty (14.42%). Similar civil penalties were imposed against business taxpayers during 2009, with a total of 970,098 civil penalty assessments. The most common of these were the failure to pay penalty and the underpayment of estimated tax penalty (55.8%).

On the criminal side, during the 2009 fiscal year, the IRS initiated 4,121 criminal investigations. Of these, 2,570 were referred for prosecution (approximately 62%) and the IRS obtained 2,105 convictions. Of the taxpayers sentenced, 81.2% were incarcerated. By way of comparison, during the 2008 fiscal year, the IRS initiated 3,749 criminal investigations, of which 2,758 were referred for prosecution.

In sum, a taxpayer’s statistical chances of being selected by the IRS for audit actually are very slim, especially in the absence of a “red flag” or matching error. That being said, the IRS has been actively hiring and recruiting new personnel over the past year, which suggests that the 2010 audit rates will surpass (perhaps significantly) the audit rates during 2009.

RECENT HIGHLIGHTS & HOT TOPICS

Recent Highlights & Hot Topics provides a brief summary of the latest breaking tax developments and happenings on a taxpayer-by-taxpayer basis.

INDIVIDUAL INCOME TAX: On July 2, 2010, the President signed the “Homebuyer Assistance Improvement Act of 2010” (the “Act”), which extends the first-time homebuyer credit for certain taxpayers who were unable to make the June 30, 2010 closing date. The Act provides that, if a binding contract to purchase a principal residence was entered into prior to May 1, 2010 with an intent to close before July 1, 2010, the first-time homebuyer credit may be claimed if the purchase is closed before October 1, 2010. The three month extension of the closing date is intended to provide tax relief to those first-time homebuyers who were unable to close due to back-logs in the processing of new mortgages.

TAX-DEFERRED EXCHANGES: In a recently issued Private Letter Ruling (PLR 201024036), the IRS ruled that the exchange of two different types of emissions credits qualified for Internal Revenue Code (“IRC”) § 1031 like-kind exchange treatment. PLR 201024036 involved the exchange of nitrogen oxide emissions credits for volatile organic compound emissions credits. Because both types of emissions at issue were ozone causing pollutants, the IRS held that the credits were like-kind in nature and character and, therefore, qualified for like-kind exchange treatment.

CRIMINAL TAX EVASION: At the close of the recent tax filing season, the IRS announced that it will be commencing a new wave of UBS-related tax evasion cases. According to the IRS, a number of new charges will be brought against U.S. individuals using accounts at the Swiss bank to evade U.S. income taxes in an attempt to make a “big splash” and remind U.S. taxpayers of their obligation to report off-shore income. Last year, UBS disclosed information regarding 250 accounts to the U.S. government and additional account disclosures are anticipated. In addition, the IRS is currently sifting through the approximately 15,000 voluntary disclosures made during last year’s off-shore amnesty program. The IRS intends to use the information gathered from those disclosures to identify other banks and advisors who

assisted U.S. taxpayers in evading U.S. income taxes.

TAX-EXEMPT ORGANIZATIONS: The IRS recently released a series of Frequently Asked Questions and Answers (“FAQs”) regarding the automatic revocation of tax-exempt status that occurs when a tax-exempt organization fails to file an annual Form 990, Return of Organization Exempt From Income Tax, for three consecutive years. Almost all tax-exempt organizations, other than churches and associations of churches, are required to file a Form 990 each year. Pursuant to IRC § 6033(j)(1), if an exempt organization fails to file a Form 990 for three consecutive years, the organization automatically loses its tax-exempt status. The FAQs make clear that the organization’s tax-exempt status is revoked on the Form 990 filing due date for the third year and that, if a tax-exempt organization’s exemption is revoked, the organization is required to file tax returns as a corporation or a trust.

EMPLOYMENT TAX: The IRS recently announced that it will not follow a new district court ruling (US v. Quality Shores, 105 A.F.T.R. 2d 2010-1110 (D. MI 2010)) that severance payments are not subject to FICA taxes. In February of 2010, a federal district court held that payments made to involuntarily terminated employees did not constitute “wages” for FICA tax purposes. According to the district court, the severance payments at issue were properly viewed as wage-replacement benefits and not taxable remuneration. The IRS, however, announced that it will follow an earlier Court of Appeals decision and continue to treat severance payments as taxable wages for FICA tax purposes. In addition, the IRS indicated that it intends to appeal the district court’s decision.

GIFT TAX: In a recent district court decision, Fischer v. U.S., 105 A.F.T.R. 2d 2010-600 (D. Ind. 2010), the court held that gifts of interests in a limited liability company did not qualify for the annual exclusion because they were gifts of a future interest.

Please be advised that this newsletter only provides brief descriptions of tax information of general interest and that any tax information contained herein was not intended and cannot be used for the purpose of: (1) avoiding penalties that may be imposed by the Internal Revenue Service; or (2) supporting, promoting, or marketing any transaction(s) or matter(s) addressed herein.

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