

Hello CFG clients . . . Brian here. These tough financial and economic times have forced many folks to change their lifestyles which, in turn, create potential changes in their personal tax situation. Some of the things I've seen this tax season are clients who, desiring to downsize but are unable to sell their existing homes, have opted instead to become landlords and rent their personal residences. I'm seeing others who have become unemployed follow their passion and start new, home-based business ventures. Still others who may have a part-time job with an employer but are also doing consulting work on the side.

With personal life changes like these, I will often be asked *what is the likelihood I will be audited or will these changes trigger an IRS audit?* Nothing drives fear into the heart of a taxpayer like the dreaded words IRS audit.

For this week's email, I'm borrowing an older MarketWatch article titled *IRS Audit Triggers and Red Flags*. Hopefully this will help to replace some of that fear and allow you to concentrate on your income earning passion and potential. If you ever have any questions regarding tax implications of any personal life changes, please don't hesitate to call or email me . . . enjoy the read!

## **IRS audit triggers and red flags – the 2010 Tax Guide from MarketWatch**

By [Andrea Coombes](#), MarketWatch

**SAN FRANCISCO (MarketWatch) -- All U.S. taxpayers have two things in common: The April 15 deadline, and a dread of getting audited.**

Take heart -- your chances of hearing from the IRS aren't all that high. In fiscal year 2008, the IRS audited 1% of the more than 137 million returns filed the year before. For taxpayers making less than \$200,000, the rate drops to 0.95%.

Those with higher incomes have more reason to worry: The audit rate of those with income higher than \$200,000 was 2.94%, and for those earning more than \$1 million it jumped to 5.57%.

Many audits are "correspondence" audits. Nobody likes to get a letter from the IRS, but it's probably less nerve-wracking than opening your door to a tax agent. More than 1 million of the almost 1.4 million audits last year were correspondence audits, while about 310,000 were field audits. See the IRS enforcement statistics (PDF).

### **Get the score**

The IRS has a few different audit methods. First, every return filed is scored by its "discriminant function" system, or DIF, said Robert P. Brennan, a former IRS agent, now an accounting instructor at Holy Family University in Philadelphia and a consultant with accounting firm CBIZ MHM.

The score is based on the IRS's study of a sample set of thousands of returns. From that study, the IRS determines what is an average and valid range for, say, the amount of charitable-contribution deductions claimed by a person earning \$100,000 a year. Then, a taxpayer with

that income who claims a much higher deduction will get a high DIF score, and is thus likelier to get audited.

That system only captures unusually high deductions; it can't find someone who is underreporting income. So the IRS also organizes projects, Brennan said, to examine certain types of businesses.

The IRS "is very concerned about the underground economy," he said, adding that the IRS estimates about \$290 billion in income goes unreported each year. As a result, in addition to high DIF scores, the tax agency focuses a keen eye on cash-based businesses, such as restaurants, gas stations and hair salons, Brennan said.

For small-business owners who receive Forms 1099, this is less of an issue, as the IRS can check what the taxpayer reports against the Form 1099 filed by the business that paid the money. In that situation, "the IRS has a record of all of your income earnings," Brennan said.

The project-based audits are focused "on the cash guy," he said. "The cleaner who does your clothing, the guy who comes in to hang your lamp or do a back porch."

### **Heed the red flags**

Keep in mind that just because a deduction, or your business income, may garner the IRS's attention doesn't mean it's wrong.

"If they're legitimate deductions, why not take them?" said Francois Hechinger, a San Francisco-based tax partner with BDO Seidman. "The deal is to be able to substantiate them if you're audited, so keep your receipts."

For instance, given that millions of taxpayers lost their jobs in 2008 -- many toward the end of the year and months after they made their usual charitable donations -- more returns are likely to show low income yet high amounts of charitable-contribution deductions.

"It may be a trigger," Hechinger said. "If they see these big deductions, they say how can you afford deductions with the income you're making?" (It's possible the IRS may take special care when auditing unemployed taxpayers. [See TaxWatch on IRS promises to help struggling taxpayers during financial crisis.](#))

But even if it increases your chances of hearing from the IRS, Hechinger said, take the deductions for which you're eligible.

Here are some more audit red flags:

- **Deduction for unreimbursed employee business expenses, such as meals and entertainment.** "That's always a popular form to audit," Brennan said. "For a lot of people, that's your classic bumping up of your expenses that you really don't have," he

said. Hechinger agreed. "When things are tough, people try to find as many deductions as they can," he said. "I don't tell my clients not to report this, I tell my clients be sure you can substantiate this."

- **Home-office deduction.** The IRS "is always interested in your office in the home," Brennan said. "Not many people qualify for an office in the home, but many people claim it."
- **Income from offshore accounts.** The tax agency is "very interested this year in foreign bank accounts," Brennan said. "They are trying to get foreign banks to disclose information of account holders. They will then take account-holder information, pull up that return and see if they disclosed it." [See story on IRS easing penalties to entice foreign-account owners to come clean.](#)
- **Wage income, plus a Schedule C with a loss.** "If a person is working full time and then [the IRS] sees a Schedule C with a loss" that may attract attention, Hechinger said. "Some people have a vineyard or horse racing activity, they will seriously question that," he said. "The IRS might say that's a hobby."
- **Carry-back of net operating losses.** Business owners who carry-back a net operating loss may well find increased IRS scrutiny, Hechinger said. It's likely, he said, the IRS may think "that because of the economy the way it is, people may be more aggressive. They want people to substantiate that loss carry-back," he said. But "if it's legitimate you've got to claim it."
- **Capital-gain exclusion on home sale.** In California, Hechinger said, the Franchise Tax Board looks closely at whether taxpayers who sold a home are correctly taking the capital-gains exclusion. Even with the downturn in the housing market, people who bought many years ago in pricey California may find they still had a substantial gain when selling their home in 2008. Any home improvements over the years would increase their basis in the home, and make it likelier that their gain falls within the capital-gains exclusion. But "make sure you can substantiate the basis," Hechinger said. "You know you spent the money on improving that house," he said, "but unfortunately people toss records over time. You have to find ways to substantiate it."

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