

A guide avoid to an IRS tax audit

# Tax audits: Uncle Sam wants you!

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NEW YORK ([CNMoney.com](http://CNMoney.com)) -- Worried about a tax audit? Maybe you should be. More Americans than ever may be subject to unwanted attention from the Internal Revenue Service this season as the government pumps billions of dollars into tax collection.

More than 1.4 million Americans were audited last year, the most in a decade. Even more audits are expected as the Obama administration plans to spend \$8.2 billion in tax enforcement initiatives in 2011, a nearly 10% increase over last year.

Being meticulous with your tax return may seem obvious, but many people aren't careful enough. And with the IRS seeking to collect every penny it can this year, you could end up paying for even the smallest mistakes.

While the IRS doesn't reveal its secret formula for flagging returns, here are some tips to avoid popping up on the auditor's radar.

## **Self-employed? Prove it's legit**

With a record-high jobless rate, many Americans have turned to self employment, making the IRS increasingly skeptical of the legitimacy of home-based businesses, said Robert Willens, a professor of taxation at Columbia Business School and president of Robert Willens LLC, a tax consulting firm.

More people are trying to turn hobbies into businesses in order to bring in a little extra money, but this won't fool the IRS. In order to prove your business is legit, you need to keep consistent and accurate records of income and expenses, said Willens. To be even safer, he suggests maintaining a separate bank account for the business, registering the business with the proper authorities and hiring an attorney and a good tax accountant.

An activity is considered a for-profit business if the gross income for any three of the most recent five years exceeds the deductions taken for the activity. If the IRS determines that a business is not engaged in for-profit, you won't be allowed to take deductions of more than the gross income from that activity, said Willens.

High expenses of self-employed individuals will also provoke suspicion from the auditor, who will look closely at travel, entertainment and automobile expenses relative to an individual's income.

## **Overseas bank accounts? 'Fess up**

As the government cracks down on offshore bank accounts, deposits abroad are likely to catch an auditor's eye this year.

While the IRS will spend most of its resources going after people with the largest deposits, all taxpayers with foreign accounts should take precaution and comply with the rules in order to avoid huge penalties, said Maureen McGetrick, a tax partner with BDO Seidman.

"Foreign bank accounts have been all over the press lately -- it's definitely a big thing this year," said McGetrick.

"People need to make sure they indicate on their tax returns if they have one, and make sure they include any interest income from that bank account on their returns," McGetrick says. If you're required to file a U. S. tax return, you must report foreign bank deposits that exceed \$10,000 at any point during the year on form 90-22.1.

## **Selling stocks? Careful with your cost basis**

Remember those stocks your grandmother gave you in 1987? If you sell them, you will need to track down the original purchase price, no matter how far back the transaction was. Reporting an unreasonable stock value on your return can easily trigger a doubletake from the IRS.

Knowing the date a stock was purchased is crucial since it determines the cost basis -- the cost of the original purchase including commissions and adjustments like stock splits -- and ultimately tells the IRS how much profit you made when you sold it.

"A lot of people, when they sell a stock, particularly if they aren't regular traders or active investors, won't know the basis of the stock," said Willens. "Maybe it was received as a gift or they bought it a long time ago, so they'll make it up."

But think twice before guessing the original value. It's important to determine the actual purchase price, whether it means verifying with your broker, hiring an accountant or calling up your Aunt Sally.

## **Making a donation? Get a receipt**

Declaring unusually large charitable donations as deductions on your tax returns is another danger zone -- especially if the amount donated is high relative to your income.

The IRS seems to be stepping up its investigations of both cash and non-cash donations this year, according to David Sands, a tax partner at Buchbinder, Tunick and Co.

But determining the value of non-cash items such as artwork, cars, clothing and furniture can be difficult. For smaller items, you'll need to assess the value yourself,

usually based on resale value at the time of donation. For most items valued over \$500, the IRS will require a qualified appraisal.

Make sure you have the receipt when taking a charitable deduction, and for any donation of more than \$250, be sure to get a letter from that charitable organization.

### **High earner? Hire a pro**

Because high earners have more income and more deductions on their returns, such as businesses, second homes, stock transactions and charitable contributions, the chances of miscalculation or inflation are much greater. The more money a person makes, the more valuable those errors become to the IRS.

"The IRS looks more closely at high earners because their financial lives are more complicated than those of lower earners," said Willens. And such complications can often lead to mistakes -- some intentional -- that the IRS will take as an invitation to dig deeper.

Willens estimates that those making more than \$200,000 a year are 50% more likely to be audited than those making less.

And those chances increase with income. The IRS reported that audits of individuals earning more than \$200,000 jumped 11% in 2009, and audits of those making more than \$1 million surged nearly 30% last year from 2008.

Wealthy taxpayers should triple-check everything and be mindful of careless omissions and inaccurate numbers, especially when reporting items that the IRS receives copies of as well, such as dividends. Hiring an accountant can be a smart move. The more complicated a tax return, the more cost-effective hiring professional help becomes, said Willens.

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