

Special Edition – Editorial

The IRS Is “Cracking Down” on More Tax Payers

I've been indicating that:

- Independent contractors have become a target for the IRS;
- I've cited various cases in which independent contractors have been re-classified to employees, and;
- The State and Federal government are looking to obtain past due taxes due to the re-classification to employees.

However, each and every one of you should know that the IRS is also stepping up efforts to make sure that tax payers are paying up. Especially, as the federal budget deficit soars;

- Approximately 40,000 more individual tax returns were audited in the fiscal year ending 2009, than in 2008.
- The number has more than doubled since 2000.
- For 2010, the tentative federal tax enforcement budget is up nearly 10% from last year.

There is no way to absolutely audit proof a tax return. If there was, I'd be a billionaire. However, there are steps you can take to minimize the chances that IRS will challenge your tax return, including ways to make sure that you don't have any of the new potential red flags that the IRS is targeting. To reduce the chances of an IRS audit, report all your income.

In the current economic climate, unreported income is a major concern of the IRS, especially if you are self employed and report income on a schedule C of IRS form 1040;

- The IRS estimates the annual tax gap between what tax payers pay and what they actually should pay approximates \$290 billion.
- IRS believes that there is under reported income;
- Under reported income accounts for 80% of this tax gap.

An agent may look beyond your W2 form and 1099 form that reports income. He/she may examine all of your checking and savings accounts. From December of the year prior to the year that is under examination through January of the following year – 14 months in all.

You have to provide information on your children's bank accounts too;

- The agents will be looking for deposits, substantially in excess of the income you reported.
- You'll be asked to explain any deposits that were not classified as income, such as proceeds from a home equity loan, account transfers or an inheritance gift.

The “bottom line”, make sure you report all of your taxable income;

- Review all your bank deposits, as if you were an IRS agent.
- Discuss it with your accountant;
- See if you can account for all deposits, in excess of the taxable income you report.

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May 21, 2010

Unfortunately, the more income the more vigilance:

- **With income of \$200,000 or less, you have approximately a 1% chance of being audited.**
- Audits of tax payers in this income group rose only slightly from 2008 – 2009.
- **With income of more than \$200,000 up to \$1MM:**
- **Your chance of an audit triples to about 3%.**
- Audits of such tax payers rose by 11% from 2008 – 2009.
- **Incomes of more than \$1MM, your chances of facing IRS scrutiny, shoot up more than 6%.**
- **Audits of 7 figure income tax payers raised by 30% from 2008 – 2009.**

The higher your income, the more vigilant you and your accountant must be to avoid errors, omissions and questionable deductions. Red flags that IRS looks for:

- Don't call a hobby a business.
- **Reporting a business that's really a hobby that is only minimally profitable, increases the common practice that the IRS frowns upon since you're not allowed to deduct losses from a hobby.**
- Be cautious about home offices; in addition to unreported income, IRS examiners often focus on deductions for home office.
- **If you're utilizing a home office, many IRS districts are now making it mandatory for a revenue agent to physically visit the tax payer's home by appointment.**
- During the visit, the agent will look around and take pictures to determine whether there really is a home office, whether it's set up exclusively for business, and how large a portion of the home is taken up by the office.

If you have a home office, what should you do? Restrict the square footage you report for a home office to less than 20% of the total space in your home.

In reference to donations, you must prove you've donated:

- The IRS appears to be taking a much closer look at cash and non cash charitable deductions, especially ones that are very large, relative to the tax payer's income.
- Giving 10% of your income to charity is far above the norm.
- The norm is 2%.

Thus donating large amounts relative to your income may be a red flag to an IRS examiner. Gifts of property, especially those valued at more than \$5,000, offer draw scrutiny. **All charitable deductions must be backed up by written verification, such as; letters from the recipient organizations or your bank statements.** Avoid making cash donations; instead, use a check or credit card. If you have taken any home buyers tax credits, it's important that you did it properly.

The Treasury Department found that about 1 out of 10 claims for the tax credit is faulty, which resulted in more than \$600MM in claims that will not be allowed;

- IRS has frozen thousands of tax refunds, and;
- They've initiated more than 100,000 of examinations of questionable claims.

For example; more than 580 people under age 18 (including a 4 year old) claimed the credit, even though they are not eligible. The IRS suspects that some high income parents (who are not eligible for credit) have their low income children claim the credit. **Another, perhaps more innocent mistake, might be claiming the credit if your income was over the limit.**

To avoid inviting an audit, be familiar with all the requirements for the home buyer's credit and follow them to the letter.

Don't exaggerate on mortgage interest. During the housing boom, many people refinanced their homes with cash out mortgages, pulling out home equity to use for living expenses. In 2009, the IRS announced that it will extend a regional project scrutinizing mortgage interest to a nationwide level by 2011. **The regional project found many people reporting large mortgage interest deductions in relation to their income – a potential red flag.** For example; if you were reporting \$20,000 in mortgage payments but only \$25,000 in income for 2009, you would be smart to attach a brief statement explaining how you can handle such a big mortgage, i.e.; you're utilizing your savings to pay the mortgage.

Of course, overseas accounts are now a red hot item for IRS:

- The IRS has announced it expects to collect \$8.5 billion in back taxes from Americans with foreign bank accounts over the next few years.
- **The IRS is pressuring foreign banks to name names.**
- In 2009, the US and Switzerland reached an agreement requiring Swiss banks to provide account information if the IRS suspects any tax invasion by account holders.

If you own or have authority over foreign financial accounts, you are required to file a report of foreign bank and financial accounts to the IRS. If the aggregate value of all your foreign accounts exceeds \$10,000 at any time during the calendar this year, be sure to do it!

I recognize that many people have filed their 2009 returns. I also recognize that many people have extended their returns for various reasons. These are the guidelines that have been provided by the IRS and you should discuss them with your accountant before you make any adjustments.

(Excepts taken from Bottom Line Personnel)

QUOTE OF THE WEEK: "Creditors have better memories than debtors" (Author Unknown)