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Forbes

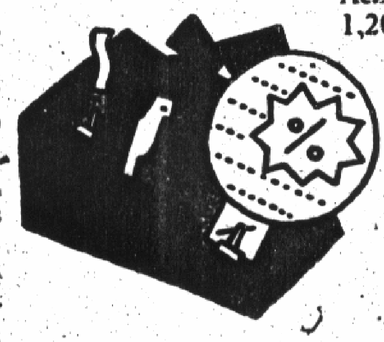
Want to minimize your chances of going head-to-head with an IRS auditor? Here are the latest tips.

Yellow lights and red lights

WHETHER YOU'RE INNOCENT or not, tax audits are too often nasty, brutish and long. And expensive. "I have a client with a legitimate $730,000 loss from the early 1980s that the IRS wrongly nailed as a tax straddle," says CPA Ralph Anderson of M.R. Weiser & Co. in New York. "The IRS is about to allow the loss, but it has taken ten years and cost $450,000 in fees." Even small matters can cost $500 and up to straighten out, says CPA Douglas Stives of Curchin & Co. in Red Bank, N.J.

So it pays to avoid waving any red flags in the Internal Revenue Service's face. But how? Here is what we know.

Overall, your chance of being audited is small. This year 115 million individual returns will be filed but only 1.1 million will be audited. The audit rate is highest in Alaska, Nevada and Wyoming. It's lowest in Massachusetts, Maine and Rhode Island. It's also higher for people with high incomes. The audit rate is 0.9% for taxpayers with adjusted gross income between $50,000 and $75,000, but 4% for those with incomes above $100,000. Like Willie Sutton, the IRS goes where the money is.



How does the IRS choose its audit victims? Unless you are part of a special group that the IRS is targeting—such as lawyers, waiters, auto dealers or Hollywood producers—chances are pretty good that your return has been selected by a scoring system based on what statisticians call a discriminant function. Banks and mail-order firms use such techniques to decide who gets a credit card, mortgage or junk-mail catalog.

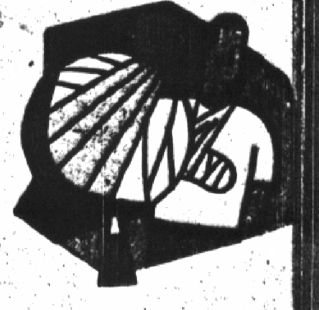
The IRS' discriminant function analyzes returns for all individuals, corporations with less than $10 million in revenue and partnerships with ten or fewer partners. It compares the entries (or lack of them) on your return with various norms. The greater the discrepancies, the higher your total score. The highest scorers are audit candidates *(see box, opposite)*.

What are the norms? In theory, they are secrets as closely guarded as the formula for Coca-Cola. In fact, however, tax pros have some idea of what will cause the IRS computer's pulse to race.

Amir Aczel, a statistics professor at Bentley College near Boston, underwent a horrendous audit for a 1989 return. Inspired by his experience, he used his knowledge of statistics to try to crack the IRS scoring system. By writing to CPAs across the country, Aczel obtained copies of 1,200 real tax returns (without identification), of which 600 were audited by the IRS. Then he compared data from the audited returns with data from the unaudited returns.

Aczel found that, in general, taxpayers should pay careful attention to three schedules: Schedule A (itemized deductions), C (profit or loss from a business) and F (profit or loss from a farm). Using his 1,200-return sample, Aczel devised "safe," "cautious" and "unsafe" zones for deductions for each schedule.

For Schedule A, which is where you deduct such things as charitable contributions, state taxes and mortgage interest, Aczel figures that a taxpayer has a very low chance of attracting the IRS' notice if his or her deductions are less than 35% of adjusted gross income. From there to 44%, the light turns yellow. Go above 44% and you're asking for trouble.



Note that these limits are far more generous than the average itemized deductions claimed by taxpayers *(see table)*.

Keep a low profile

Adjusted gross income	Total itemized deductions*	Taxes	Interest†	Charitable contribution
$25,000 to $30,000	34.8%	8.3%	14.5%	3.9%
30,000 to 40,000	28.1	7.8	12.6	3.5
40,000 to 50,000	24.7	7.3	10.8	3.1
50,000 to 75,000	21.3	7.2	9.4	2.6
75,000 to 100,000	19.9	6.9	8.3	2.9
100,000 to 200,000	18.5	7.7	7.2	2.8
200,000 and over	14.3	8.1	4.0	3.3

*Reflects both some categories not shown (such as casualty losses) and certain adjustments, including one that trims the total by 3% of income over $108,450. †Substantially all is mortgage interest.

Source: Statistics of Income Bulletin, IRS, Fall 1994.

Do your tax deductions stick out? Here are average deductions as a percent of adjusted gross income for 1993 returns.

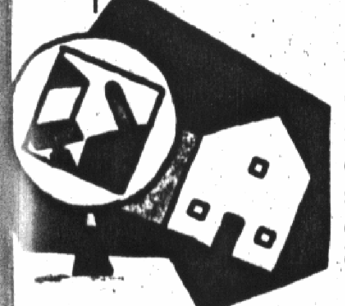
The ultimate audit

THE WORST AUDIT is one that nobody, no matter how careful, can avoid: the "taxpayer compliance measurement program" audit, TCMP for short. Every five years the IRS does a soup-to-nuts audit of 150,000 hapless taxpayers chosen at random. The IRS says its aim is not to collect more revenue but to get data to update its audit scoring system *(see story)*. This is one of those years. Letters will begin going out in October.

What's a TCMP audit like? We asked former IRS Commissioner Lawrence Gibbs, who was a tax lawyer in Dallas when the IRS roulette wheel landed on his number during the early 1980s. Gibbs says the auditor made him verify each mortgage interest payment and show that unidentified bank deposits were not hidden income but rather reimbursed expenses. But he didn't have to produce his children, as some TCMP auditors ask of taxpayers with dependent deductions.

Gibbs keeps neat records and plays by the rules, so his TCMP audit took only a day and a half and he didn't owe an extra dime.

Gibbs was also lucky that he was in the tax business. For nonprofessionals, a TCMP can be brutal. "These audits can easily take five or six times as long as a normal exam," says David Marcus, a CPA with Paneth, Haber & Zimmerman in New York. "And they cause problems between us and our clients. I had one who owed very little extra in taxes, but his bill from me was $10,000." –L.S.



For Schedule C, business profits and losses, the caution zone starts when total expenses hit 52% of gross income from that schedule. The red light flashes when they top 67%. For Schedule F, the caution zone starts when losses hit 59% of gross farm income, the unsafe zone at 71%.

What if you file both Schedule A and Schedule C? Then Aczel suggests that you combine the Schedule C percentage with 1.5 times the Schedule A percentage. Caution point: 105%. But he emphasizes that it's still important to make sure that each schedule by itself falls below the danger point.

Aczel wishes he could have taken his own advice. The year he was audited, his Schedule C expenses for writing textbooks were 85% of his Schedule C income, far into the red zone. (For more on Aczel's findings, see his *How to Beat the IRS at Its Own Game*, Four Walls Eight Windows, 1994.)

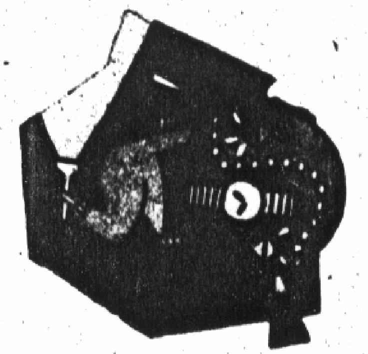
Tax accountants offer these further tips on how you can minimize the risk of an audit.

Pay attention to details. Use the mailing sticker the IRS provides to avoid having a keypunch operator make mistakes typing it in. Be sure to assemble the schedules in the order the IRS specifies in the upper right corner of each. Avoid round numbers where they don't make sense—such as with income—and use them where they do—as with charitable contributions. "Nobody gives $9,099 to a college," says New York CPA Stuart Kessler of Goldstein Golub Kessler.

Explain things that seem odd or suspicious. It is rare, for example, that affluent taxpayers have enough medical expenses (i.e., beyond 7.5% of adjusted gross income) to qualify for a deduction. If you do, consider attaching a letter explaining why. But don't tell the IRS more than it needs to know. "Never explain that a $200 deduction was for basketball tickets, when 'entertainment expense' would do," says David Marcus, a CPA with Paneth, Haber & Zimmerman in New York.

Beware the home office deduction. Experts say it's an open invitation to IRS harassment. Consider the case of a client of M.R. Weiser's Anderson. He took a totally justified $36,000 deduction for a home office for his real estate business in 1989. But defending the deduction, which the IRS allowed in full last year, cost him $55,000 in fees.

Beware casualty losses. Especially if they don't come from a general disaster such as an earthquake or flood. With casualties and thefts, the limits on deductibility



are so stringent that the IRS figures hardly anybody legitimately qualifies.

Be careful with charitable contributions, especially those of property. A new rule this year says you must have a receipt from a charity—not just a canceled check—in your hand when you take a deduction over $250. If you round up the receipt later on, then the IRS can disallow it. Keep contributions of property below $500—unless you're donating a Picasso—so you don't have to attach an itemized list to your return or an appraisal. And if you are especially charitable (more than, say, 12% of income), be prepared to document it.

Don't let your enemies know your tax sins. The IRS sometimes pays small cash bounties to tipsters. For many of these pigeons, their biggest reward is putting the taxpayer through hell with the IRS. Most information comes from scorned lovers or ex-spouses.

Don't be famous. As Willie Nelson, Darryl Strawberry and Leona Helmsley can all attest, the IRS likes to get maximum publicity from its limited auditing resources. Keep a low profile. Don't brag to a reporter about your tax shelters. –L.S.