PERSPECTIVE

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How To Steer Clear Of Both State And Federal Tax Audits

By Robert W. Wood

No one wants to fight with the IRS or the California Franchise Tax Board (FTB). Both agencies audit, and both can be tough on taxpayers. Many tax professionals say the FTB is tougher in audits. Certainly, that is true when it comes to tax collections. There are usually ways to buy considerable time and concessions from the IRS. With the FTB, rarely.

But how do you avoid audits in the first place? It's a big worry, especially when the IRS can often audit six tax years not three. The FTB always gets at least four years. Start by filing timely and careful tax returns, and paying your taxes on time.

Still, there's always the risk of an audit. There are numerous theories for what triggers one. Even so, there are some basic things you can do to *reduce* your chances of being selected, and to make any interactions with the IRS less traumatic. Start by being reasonable.

Do not be afraid to take deductions and losses to which you are entitled. However, do not take tax positions you are uncomfortable defending. Call it karma. If you generally take reasonable tax positions, you may not need to defend them.

You might even take aggressive positions, but it's best to do it with your documents and authorities lined up. That way, if you *do* face an audit, it will likely be far easier. Many people speculate that certain items trigger an audit: home office deductions, passive losses, schedule C (sole proprietorship) activities, etc.

They can all be problematic, but in the end, you can't predict the trigger (and you can drive yourself crazy trying). So, try to be reasonable about every item on your return. If you don't have a decent claim for a home office, don't claim it. If your money-losing sole proprietorship is really a fun hobby, treat it that way.

When you do put something on your return, don't over-explain. You'd be surprised how many professionals and amateurs alike try to submit too much information. If your return is complex, you may need to add explanations or disclosures in footnotes. Be concise, truthful and accurate, but don't provide copies of sales agreements, settlement agreements, bank statements, etc., unless you are later asked to by the IRS.

Disclosures can be made on regular paper or special IRS forms. Tax return preparers distinguish "white paper" disclosures from those on IRS Forms 8275. But either can be used any time you need to disclose something that can't be adequately disclosed on the forms. There is another form, 8275-R, but you shouldn't be filing a Form 8275-R — or taking a tax return position that would require it — without professional help.

What about using a tax preparer? Some people say that a return prepared by a professional is less likely to be audited, but there's little reliable data to support it. Nevertheless, having a professional prepare your return—or at least give you advice on anything quirky — is a good idea. If you prepare your own return, using a commercially available software package, such as Intuit's Turbotax or H&R Block's Taxcut, can make it easier and more reliable.

If your tax software produces some result you consider wrong, don't simply override it. Or, at least investigate before you do. Example: You're not rich and can't understand why the software has spit out a Form 6251 showing you owe the alternative minimum tax. The software is probably right, especially if you live in a high tax state like California.

Fill out the right forms, and do so completely. Make sure you add, subtract and multiply accurately. Check your numbers through each step, and do some simple math checks when you finish. This is another reason to use a software program. If you do make a math mistake, you are likely to get a correction notice from the IRS or FTB. Your goal is to minimize such interaction with the IRS or FTB.

Keep track of all your Forms 1099! IRS Forms 1099 come in many varieties, including 1099-INT for interest, 1099-DIV for dividends, 1099-G for tax refunds, 1099-R for pensions and 1099-MISC for miscellaneous income. These forms are sent by payers of such funds to both you and the IRS. So regardless of how many 1099s you receive, make sure they all are accounted for on your return.

There are also Forms 1098 which lenders send (to you and the IRS) recording how much interest you paid. The IRS even has forms for many non-cash items you must report on your taxes. One way to enhance the chance of audit is to fail to account for something. Yet you may not want to ask if you are missing an IRS Form 1099. If a Form 1099 is wrong — say it reports more income than you had — you can explain or deduct it on the return, but you need to first report it.

No matter how careful or lucky you are, there is no way to guarantee you'll never have a tax controversy. Yes, luck plays a part. Still, sometimes your number just comes up. Although audit rates for most types of tax returns are low, there is always a chance you will be examined. Try to be ready. It can be the best way to rest easy, and just might make it less likely that you be audited after all.

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