PERSPECTIVE

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How to avoid being audited

By Robert W. Wood

Even if you're a lawyer who relishes litigation, you probably do not want to fight with the Internal Revenue Service about your *own* taxes. You want your personal and business income tax returns as well as your payroll tax returns to sail through unnoticed. The same is true with California state tax income tax returns filed with the Franchise Tax Board, and even for sales tax returns filed with the California State Board of Equalization.

In that sense, tax returns are a little like the bar exam. You have to file tax returns and comply with the rules, but you want to get by with a minimum of fuss. That is one reason why there's such a mystique about avoiding an audit.

Tax lawyers and accountants are required to assume that every return will be examined when they give tax advice. Put differently, tax advisers can't base their advice on the fact that it is highly likely that the return will never be audited. If a tax lawyer says there is a 50/50 chance that a deduction will be upheld, it must be based on the return being audited.

Theories for what triggers an audit abound. The subject is often debated among tax lawyers and accountants. Even so, there are some basic steps you can take to reduce your chances of being selected for an audit, or if you are, to at least make any interactions with the IRS less traumatic.

Don't claim doubtful deductions.

Judge Learned Hand wrote what is probably the most famous statement of the taxpayer's role in the tax system and ability to do tax planning:

"Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes." *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934).

You should not be afraid to take deductions and losses to which you are entitled, but you should also not take tax positions you aren't comfortable defending. If you take reasonable tax positions, you'll likely find you won't end up needing to defend them. And if you do face an audit, it will likely be far easier.

There are many old wives tales saying that certain items trigger an audit: home office deductions, passive losses, schedule C (sole proprietorship) activities, etc. You can't predict the trigger (and you can drive yourself crazy trying), but you can adopt the "be reasonable" mantra about every item on your return. So if you don't have a decent claim for a home office deduction, don't claim it. If your money-losing sole proprietorship is really more a fun hobby, treat it as such.

Use a professional return preparer or software.

Some argue 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 advise on anything quirky — is a good idea if it makes the return more error-free.

If you do your own return, using one of the commercially available software packages will probably make it easier to complete and more reliable. If the software produces some result you consider wrong, do not simply override it. (Or, at least investigate before you do.)

Check your math and assemble your return correctly.

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.

Follow the IRS instructions for assembling your return. Usually, that means the return itself, followed by schedules in alphabetical order, ancillary forms in numerical order, and plain paper statements and footnotes at the end. Attach Forms W-2 where specified, but don't attach forms that are not required such as 1099s.

If you do make a math mistake, you are likely to get a math correction notice from the IRS. This is not an audit. Your goal should be to minimize such interaction with the IRS bureaucracy, which isn't known for the best mail handling practices or responsiveness. Moreover, you don't want a simple notice to escalate into a full-blown audit.

Account for every Form 1099 and K-1.

This item is terribly important. 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 those making payment to make sure the recipient reports it. If you are a partner in a partnership or LLC, you will receive a Form K-1.

A copy of each Form 1099 goes to the IRS and to the recipient. Regardless of how many Forms 1099 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 matches your return against the 1098s and 1099s.

One way to guarantee an IRS query is to fail to account for something like a Form 1099 or K-1. 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. If a K-1 is wrong and you can't get the partnership or LLC to correct it, there is a special form to report the discrepancy.

Avoid Schedule C.

Schedule C — for proprietorship business activity — is one of the most likely types of returns (or parts of returns) to be examined. Fill it out if you operate a small business that is not in a legal entity (such as a corporation, LLC or partnership). Examples are small enterprises you run from your garage, on the internet, or on weekends even though the bulk of your income may come from wages from your regular job. Schedule C is also the primary place the IRS can audit "hobby" activities that you claim are a business but the IRS disputes. Be especially wary if you have several years of losses in a row.

In my next column I'll cover 5 more ways to avoid an audit.

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