PERSPECTIVE

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IRS Audits Are At An 11-Year Low

By Robert W. Wood

Are you happy that the Internal Revenue Service has 22 percent fewer revenue agents than just five years ago? Are you happy that IRS audits of individuals have dropped to an 11-year low? It is hard not to breathe a sigh of relief about these developments.

After all, no matter how patriotic you are, and no matter how pristine your books, no one wants to be audited. Even if you think you've reported everything and done it properly, providing receipts and reasons for what you did is maddening. The IRS is trained to find something you did wrong, right?

If you are anything like most people, you want to file your return, pay your tax, and remain undisturbed. Of course, when it comes to *just how much* tax you have to pay, you may want to be mindful of Learned Hand's famous iteration of the taxpayer's role in the system. Judge Hand admonished that there is not even a patriotic duty to increase one's taxes.

There is nothing sinister in so arranging affairs as to keep taxes as low as possible. Yet different taxpayers have varying comfort levels with degrees of risk on a tax return. Most people want to pay less but also want to steer clear of an audit or dispute.

Amazingly, the IRS is now auditing only 0.84 percent of individual taxpayers. That's less than 1 out of 100 and falling. An audit might be in person or by correspondence, but there's a small chance of either. The IRS isn't happy about this, and the IRS Chief—the one whom the Republicans want to impeach— is asking for more money to ramp up audits.

But it is just possible that a low audit rate might hurt rather than help you. Think of it like knowing that there is only one police officer in your state to give speeding tickets. Wouldn't you be more likely to speed? You might take liberties and drive dangerously.

In the same way, this low audit rate is likely to embolden some taxpayers and tax advisers. They may feel like they are in the clear. Statistically speaking, they might be. But *someone* is going to get audited.

And you should prepare as if you will be audited, not assuming that you will not be. If you are fully prepared for an audit, with documentation, receipts, log books, perhaps even a tax opinion, you probably won't need them! That is the odd karma about being prepared.

Conversely, suppose that you figure you don't need any of those things and can produce if and when you are audited? You guessed it, you probably will get audited. What's more, you won't be able to quickly produce records or responses. Even if you do, the documents may be less persuasive to the IRS than contemporaneous ones would be.

For example, a tax opinion prepared at audit time is rarely entitled to much deference. How long are you at risk? The IRS usually has three years after you file to audit you. But frequently, the IRS says it needs more time. The IRS will ask you to sign a form extending the statute, usually for a year. You may be able to limit the time or scope, but most tax advisers tell clients to agree.

An exception to the three year rule is if you omit more than 25 percent of your income. In that case, the IRS gets double that time, six years. The IRS also gets six years to audit if you omitted more than $5,000 of foreign income (say, interest on an overseas account).

For unfiled tax returns, criminal violations, or fraud, the IRS has no time limit. In most criminal or civil tax cases, though, the practical limit is six years. And in some cases, even if you file your return, if you miss some tax forms, the IRS can audit forever. It is rare, but it happens.

For these and many other reasons, you should never throw out your own copies of your old tax returns—ever. But after a time—many people say seven years to be safe—you should be able to throw out records and receipts. Still, keep in mind that some records should be kept forever—like improvements to property that go into your basis. If you remodel your kitchen and sell your house 20 years later, the receipts for your remodeling job are still relevant.

You might think that keeping good records is something that can help you only if you actually end up in a tax controversy. Yet believe it or not, there is something about keeping good records that can keep you out of trouble in the first place. Maybe it's karma.

Whatever you call it, there is a cosmic notion that when you follow the Boy Scout's motto and are prepared, you probably won't need to be. Or perhaps it is some larger principle at work. The fact is that good records reduce the likelihood you will face a tax dispute, at least in my experience.

Besides, if you keep good records, your numbers will likely be more reliable. That is a tangible effect of being well-organized. There's no way to guarantee that you'll never have a tax controversy, no matter how careful you are. Although you should be reasonable and you should not be too aggressive in any tax filing, these are often questions of degree.

Moreover, no matter how careful and how conservative you are, sometimes your number just comes up. So do what you can to minimize your exposure. It is comforting to know that your chances of an IRS audit are declining. But *someone* will be audited, and you might be the one. The best way to avoid much of the pain is to be prepared.

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