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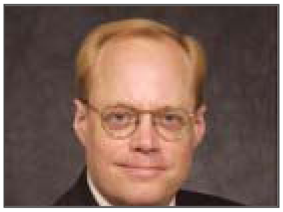

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Ironically, Slim Chance Of IRS Audit Means Big Tax Problems

The news that [IRS audits of individuals have dropped to an 11-year low] means there are a lot of happy taxpayers. After all, 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. And often seems dangerous. The IRS is trained to find *something* you did wrong, right?

The IRS is now auditing only 0.84% 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 Chief—the one whom the [Republicans want to impeach]—is asking for more money to ramp up audits, but Congress isn't about to fork it over. The IRS has 22% fewer revenue agents than it had five years ago.

So how can infrequent audits hurt 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 an when you are audited?

You guessed it, you probably will get audited. What's more, you won't be able to quickly produce all the things you think you can. Even if you do, the documents will almost certainly be much less persuasive to the IRS than contemporaneous ones would be. And a tax opinion prepared at audit time is rarely entitled to much deference!

In short, prepare up front and assume that you'll be audited. How long are you at risk? Start with the basic rule that the IRS *usually* has three years after you file to audit you. But this is often extended, sometimes voluntarily. Frequently, the IRS says it needs more time to audit. The IRS asks you to sign a form extending the statute, usually for a year. Most tax advisers tell clients to agree, but get some professional advice. You may be able to limit the time or scope.

An exception to the three year rule is if you omit more than 25% 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.

The statute of limitations on taxes is a fundamental rule allowing taxpayers to cut off their exposure. You should never throw out 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.

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 really prepared.

For alerts to future tax articles, email me at Wood@WoodLLP.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.