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# Financial Fax

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(Including the November 2006 Federal Tax Calendar)

## LATEST IRS AUDIT FIGURES

**Q:** Do you know the difference between a colonoscopy and an IRS audit?

**A:** There is no difference.

### Here They Are!

**T**he latest available (2005) IRS audit percentages have been released.

- About 131 million individual income-tax returns were filed—and over 1.2 million individuals were audited (0.92%). This is an increase of **over 20%** in the total number of audits over 2004!
- Audits of small businesses also **more than doubled** the 2004 rates, with almost 18,000 small businesses examined.
- Audits of individual taxpayers with incomes over \$100,000 are at a 10-year high, with over 220,000 examinations.
- The IRS characterizes the **overall** audit rate of about 1.5% as “still being too low.”

As always, it's much more meaningful to dig into the details of various **categories** of income-tax returns—and see how they are audited. The “winners” (really losers) continue to be Schedule C filers (those who are self-employed, not incorporated, and file Schedule C as part of their individual income-tax returns). Audits of Schedule C filers with **gross income under \$25,000** were the single highest individual audit category, followed closely by the over \$100,000 gross income category.

The IRS, as always, is highly suspicious of that first category: (a) if net losses are claimed that they can reclassify as non-deductible “hobby losses”; or (b) if there

are “questionable deductions” that are really personal expenses. It's their **least** favorite filing category...and their highest individual audit category...in which they have considerable success in their examinations....

To avoid all that, you might want to consider incorporation (or form a partnership or LLC, perhaps with your spouse)—just to avoid that “Schedule C” status! This is particularly true for that second highest audit category of over \$100,000. At this point you are running a true “business” and the many advantages of other forms of business entities become more and more attractive. As a final incentive, **all** the 2005 Schedule C examination rates are **higher** than those in 2004. Ugh!

#### Individual Returns (with Schedule C):

| Gross Income       | Audit Rate |       |
|--------------------|------------|-------|
|                    | 2005       | 2004  |
| Under \$25,000     | 3.68%      | 3.15% |
| \$25,000-\$99,999  | 2.21%      | 1.47% |
| \$100,000 and over | 3.65%      | 1.86% |

Now compare the preceding audit rates to the following tax returns **without** Schedules C, and you will realize that **not one** of the following are as high as **any** of the preceding; and again all the 2005 audit rates are higher than 2004.

#### Individual Returns (without Schedule C):

| Gross Income              | Audit Rate |       |
|---------------------------|------------|-------|
|                           | 2005       | 2004  |
| Form 1040A under \$25,000 | 0.52%      | 0.50% |
| Form 1040 under \$25,000  | 1.48%      | 1.26% |
| \$25,000-\$49,999         | 0.60%      | 0.43% |
| \$50,000-\$99,999         | 0.57%      | 0.44% |
| \$100,000 and over        | 1.41%      | 1.39% |

(Note that the following corporation examination figures **do not include** S corporation tax returns. The IRS does not break down S corporation audit categories by total assets, but only provides one figure for all S corporations that are audited. If you can't wait, that overall audit percentage for **all** S corporations is 0.30% (repeated later),

#### Corporations NO Balance Sheet Included (excluding S corporations, as noted above):

|                          | Audit Rate |       |
|--------------------------|------------|-------|
|                          | 2005       | 2004  |
| No balance sheet returns | 0.53%      | 0.38% |

#### Corporations by Total Assets—Balance Sheet Included (excluding S corporations, as noted above):

|                             |        |        |
|-----------------------------|--------|--------|
| Under \$250,000             | 0.74%  | 0.20%  |
| \$250,000-\$999,999         | 0.96%  | 0.30%  |
| \$1,000,000-\$4,999,999     | 1.02%  | 0.66%  |
| \$5,000,000-\$9,999,999     | 2.67%  | 2.13%  |
| \$10,000,000-\$49,999,999   | 12.31% | 9.35%  |
| \$50,000,000-\$99,999,999   | 16.42% | 12.85% |
| \$100,000,000-\$249,999,999 | 17.49% | 16.85% |
| \$250,000,000 or more       | 44.06% | 39.81% |

Current IRS regulations do not require that a corporation supply its balance sheet if both total gross receipts **and** total assets are less than \$250,000. This results in the above IRS category of “no balance sheet returns.” Also, note the huge percentage increases in audits of the **lower** three asset categories of returns shown above.

#### Audit Rates for Estate Tax Returns by Size of Gross Estate:

|                         |        |
|-------------------------|--------|
| Under \$1,500,000       | 1.40%  |
| \$1,500,000-\$4,999,999 | 12.79% |
| \$5,000,000 or more     | 28.12% |

**TAX TIP:** You can bet that as the size of the estate increases over \$5 million—the audit percentage increases as well. For example, a \$40 million return is far more likely to be audited than a \$5 million return.

### Generally Nontaxable Returns—Overall Audit Rates

|                                 |        |
|---------------------------------|--------|
| Partnership Returns             | 0.33%  |
| S Corporation Returns           | 0.30%  |
| Gift Tax Returns                | 0.81%  |
| Tax Exempt Organization Returns | 0.006% |

**TAX TIP:** That absurdly low audit percentage for tax exempt organizations may be one reason why they are now finding quite a few questionable organizations operating under the guise of tax exempt "charities." Along with many phony religious organizations where the leaders live like kings—but pay little or no taxes. In actual numbers, the IRS audited only 4,900 tax-exempt organizations, out of a total of 849,000 of such returns filed. This super-low audit rate of 6/100ths of 1% is consistent from year to year...and is a real loophole....

### More on Audits of Schedules C

**W**ithin the highest audit category of Schedules C with gross income of less than \$25,000, are three sub-categories that, in our opinion, contain a much higher audit level than the stated overall average:

- They show a net **loss**, with expenses exceeding (the under \$25,000) gross income.
- They report **zero** income and, of course, report a net loss after expenses.
- Their return contains **multiple** Schedules C. Two, three, five schedules, etc.

**CAUTION:** In the first two cases the **magnitude** of the loss is important. A \$300 loss might be ignored. A \$15,000 loss is a different thing. As an absolute generalized guess, but based on our experience, those three noted above might have an audit frequency of 10% to 20%. Further ideas....

- Make sure the reported gross income on Schedule C equals or exceeds the total

of all Forms 1099 that you received. Further, the IRS considers your reported income even more "honest," if it somewhat **exceeds** the totals of the Forms 1099 (since some small income is usually not reported on a Form 1099).

- If the total deductions on your Schedule C are about 50% of the income, or less—that usually appears to be "reasonable" in the audit eyes of the IRS. When the deductions hit about 65%—you are headed for trouble! In between those percentages is the "toss-up" area (they toss all the tax returns up in the air—and the ones that stick to the ceiling—they don't audit).

- If you have some outside self-employment income (fees, commissions, part-time activities, etc.), with **no** offsetting expenses—report it on Line 21, Page 1, Form 1040 as "other income." This legally **avoids** the filing of a Schedule C, which, of course, itself is a **major** audit trigger. **NOTE:** You still must pay any applicable self-employment tax **and** you still can claim a Keogh, SEP and/or self-employed medical insurance deduction, if applicable.

- Be aware that the IRS is very suspicious if you file a Schedule C **and** claim only the standard (rather than itemized) deductions. Their theory is that in such cases, many of the itemized deductions (interest, taxes, contributions, etc.) are **also** being claimed on your Schedule C—and you are "double dipping."

### The TPI Can Catch You!

**T**he IRS has a very clever technique for selecting tax returns for audit—particularly ones that might otherwise easily escape. It's called their Total Positive Income (TPI) screening technique. **SIMPLIFIED EXAMPLE:** You sold that business you started 25 years ago—for \$15 million! Then, you bought a so-called "tax shelter" from a national CPA firm. This (supposedly) created a deductible loss of \$14,950,000. **SO,** the two offset each other on your tax return—leaving you with adjusted gross income of \$50,000. Not a very likely candidate for audit, one would suppose....

However, along comes the TPI selection technique, which **ignores** all negative

numbers (losses, etc.) on your tax return. So your TPI comes out to \$15,000,000 and the audit selection process goes "Bingo"! Then, when you are audited, they dig and dig into your supposed "loss," and those who sold it to you. Frequently with very adverse results for all concerned.

### Reasons to File for an Extension

**D**espite repeated denials by the IRS, there is more than a little evidence that filing your tax return close to the latest legal due date of October 15—**reduces** your chances of being audited. All this requires is that you send an **automatic** six-month extension of time to file (using Form 4868). No reason is required to obtain this extension of time to **file** (although you should **pay** at least 90% of your total tax liability by April 15th of each year). Our own experience with many, many IRS audits tends to bear this out....

The reasoning goes like this. About 94% of all returns are filed by April 15. As returns are filed, the IRS computer steadily scores them and some are selected for inclusion in the IRS audit inventory. However, their entire 1% or so audit selection quota may well be **filled** before the delayed filing of your return, suggested to be near October 15. Your return will certainly avoid the **first** (and maybe **second**) batch of returns so selected. Further, late-filed returns may not even be computer scored, but even if they **are** selected for audit—it's quite possible that time could run out on the IRS before they can actually audit you within the statutory three-year limit. Delays, budget and scheduling problems usually arise—and **they are always on your side!**

Among others with this opinion, was a Professor of Statistics at a major university, using a Cray computer, analyzed thousands of tax returns and their related audit frequency. His final opinion was that the **later** a tax return is filed (e.g., around October 10) the **less** chance of an IRS audit; and that many **late-filed** returns that he analyzed and felt should **absolutely** be audited—usually were **not**. His findings were published in a small book, now out of print, which I read every night before I go to bed...and bless my Mommy, my Daddy and the Professor.

To sum up, your return might never even end up in that last group selected to be examined—or even if it **does**, they may never get to it in time. So don't be afraid of an extension. Like my mother's chicken soup...it couldn't hurt....

### The Myth and the Math of Extensions

**A**ccording to Chief Inspector Jacques Clouseau, a "myth" is a little flying bug that eats holes in your woolen clothes. That's not the myth we are discussing today....

There are a large number of taxpayers who firmly believe that getting an extension of time to file their tax return is a virtual guarantee that they will be audited! Besides the reasons already stated, let's consider the math.

Beginning in 2006, an automatic, "no reason required," individual six-month extension became available. It's estimated that perhaps 10 million taxpayers filed these in 2006, for the tax year 2005—and that this figure will grow as the word gets out about this new and easier rule.

The IRS audited a **total** of about 1.2 million individual tax returns. But about 10 million individual returns go on extension. Gee, it's a little hard to reconcile those two figures, if filing an extension causes an almost automatic IRS audit of those 10 million returns...isn't it? (You see—10 million is way more than 1.2 million **total** audits.) Plus the fact that there has to be room for them to audit the vast majority of tax returns **not** on extension. Right? So the math **alone** makes this an "old wives tale"—as does our own experience, year after year after year. On the contrary, there is a considerable body of logic and evidence that filing on extension and sending really late (e.g., October 10th) helps to avoid an audit, as already discussed.

So this is just one of the many **myths** about the IRS, like the absurdity of avoiding audits by: filing in early January; or filing on April 14th; not itemizing (legitimate) deductions; preparing a mostly illegible tax return; using your ex-wife's social security number; attaching too many documents; attaching too few; "losing" some documents; "the dog ate my records"; mailing to the wrong

address; putting too few stamps on the envelope; putting too many on; sending in a statement that you are mentally disabled...or that your CPA is.

LOGIC TEST: (1) I have never gone on extension and always filed my tax return on time. (2) I have never been audited by the IRS. (3) **Therefore**, going on extension causes you to be audited. True or false?

### High-income Taxpayers

**T**he IRS is sticking to their absurd definition that taxpayers with incomes over \$100,000 are "high income" and much more likely to be audited. How about married taxpayers, both working, one spouse earns \$85,000 and the other \$65,000—both reported to the IRS on Forms W-2. Their interest and dividend income is also directly reported to the IRS, as is their mortgage interest and securities sales. Wow! What is there left to audit by the IRS? Point being that the **generalization** those likely audits are on **all** those "over \$100,000 income" is a misnomer. However, here are some likely (over \$100,000) audit candidates:

- Tax returns that contain amounts not readily verifiable by the IRS (many Schedules C; or income not directly reported to the IRS; large expense deductions; etc.).
- Tax returns with huge losses offsetting their other (more "normal") income. (This was typical of the "tax shelters" that were peddled by the national CPA firms and others. Now in complete disrepute after the IRS has virtually destroyed them.)
- Tax returns with income **much** higher than \$100,000, and the larger the income—the greater the odds.
- Very high income returns **not** filed on extension, as we have discussed.

**And that's all you get this month about the IRS audits....**

### —Federal Tax Calendar— November 2006

**Notice:** This calendar does not attempt to cover every federal tax-filing deadline and it does not include any payroll or excise tax-deposit dates. These reminders are for some of the most common federal tax transactions. In each case *the last possible due date without penalty* is listed below.

**1:** If you are a shareholder in an S-corporation expecting a loss, and with a fiscal year ending this month—verify if you have sufficient "basis" to deduct those losses in full.

If your **business** receives "cash" (i.e., currency or negotiable instruments) of over \$10,000, in payment for either merchandise or services, in one transaction or a series of related transactions—you must report the details to the IRS **within 15-days** on Form 8300. The penalty for intentional failure to file is the **greater** of \$25,000 or the amount of cash received up to \$100,000.

**15:** Today is the last day to file an amended corporation income-tax return (Form 1120-X) for the fiscal year ended August 31, 2003. **TAX TIPS:** (1) We never recommend filing an amended tax return if a small sum is involved—you are giving the IRS a "second look" at your **entire** tax return and you might trigger an IRS audit—all over a trivial refund amount; (2) If you **are** filing, wait until just **before** the three-year statute of limitations expires to file an **amended** tax return. Then it's only the amended items that can be audited by the IRS—instead of your entire return.

Corporations deposit your estimated tax installment if your fiscal-year end is February 28, May 31, July 31 or November 30. Use Form 8109 or, if required, the Electronic Funds Transfer (EFT) method.

Corporations, whose fiscal year began September 1, 2006, have until today to either elect S-Corporation status (using Form 2553) or revoke such status, for this **current** fiscal year. **TAX TIP:** Always have the **spouses** of each shareholder sign the consent or revocation as well, or the election/revocation may be void.

Corporation income-tax returns are due

today, if the fiscal-year end was August 31, 2006. Otherwise, apply for an automatic six-month extension of time to file, using Form 7004. **TAX TIP:** The filing of this extension automatically extends the due date of the corporate retirement-plan contribution by the same six months.

Corporations with a fiscal-year end of August 31, 2006, who have overpaid their estimated income tax, have until today to file an application for a quick (90 day) refund, using Form 4466. **TAX TIPS:** (1) The IRS requires that the refund claim be filed **before** the filing of the related corporation income-tax return (Form 1120), but **after** the close of the tax year; (2) an extension of time to file the corporation's income-tax return will **not** extend the time for filing refund Form 4466—in other words you **must** file this form within 75 days after the corporate year end; (3) to qualify for this quick refund procedure the overpayment amount must be: (a) at least 10% of the corporation's actual tax liability and (b) over \$500.

If your **current** fiscal year appears to be headed for a loss, consider filing Form 1138 "Extension of Time for Payment of Taxes by a Corporation Expecting a Net Operating Loss Carryback" and then **not** paying the C-corporation taxes that are otherwise due today. This will grant your corporation an extension of time to pay what is still owed on **last year's** tax bill. (Interest is payable on the full amount of the postponed tax.) Form 1138 must be filed **after** the beginning of the tax year in which the loss is expected, but **before** the due date for paying the previous year's federal income-tax bill. **TAX TIP:** The Form 1138 can also be filed with Form 7004 (Application for Automatic Extension of Time to File Corporation Income-Tax Return). When the two forms are filed together, the affect is to reduce or eliminate the amount of federal income tax that would otherwise be required to pay with the Form 7004.

If your corporation has a loss for the year that will be carried back to get a refund of taxes paid in prior years—here's how to do it. You can get a "quick refund" by filing IRS Form 1139 **after** the applicable tax return has been filed. You must file the form within one year after the end of the

tax year of the loss, but...the sooner the better!

Corporation income-tax returns are due today, if the fiscal-year end was February 28, 2006 and the company previously obtained a six-month extension of time to file. **TAX TIP:** If your **current** fiscal year appears to be headed for a loss, consider filing Form 1138 "Extension of Time for Payment of Taxes by a Corporation Expecting a Net Operating Loss Carryback" and then **not** paying the C-corporation taxes that are otherwise due today.

Pay any balances still owing for retirement plan contributions, if the corporate fiscal-year end was August 31, 2006, or if a six-month extension of time to file was obtained and the fiscal-year end was February 28, 2006. **TAX TIP:** Late payments are subject to a 10% excise-tax penalty.

**30:** File Form 4419 for initial IRS approval to file information returns (Forms 1099, etc.) on magnetic media for the coming calendar year 2007, or file Form 8508 to request a one-year waiver of the magnetic media filing requirements for these forms.

Annual reports for retirement plans with a fiscal-year end of April 30, 2006 are due today. These reports include Forms 5500, 5500-C, 5500-R and 5500-EZ. **TAX TIP:** There are **killer** late filing penalties for these forms of up to **\$1,000 a day** and an additional penalty of \$1,000 for the late filing of Schedule B of each Form 5500.

If today is the end of your fiscal year: salaries, bonuses and other forms of

compensation for more than 50% shareholders, must be paid by today—in order to deduct such expenses in this **current** fiscal year. You cannot **accrue** and deduct any such amounts owing to "over 50% shareholders"—they must actually be paid first. The same rule applies to unpaid interest, rents, commissions, etc. (and remember that "related parties," such as your spouse and children, are also covered by this restrictive rule.)

If your fiscal year ends today, this is your last chance to "adopt" a retirement plan (i.e., execute the necessary documents) and actually open the plan bank account (with \$100 or so). Then the company can claim a retirement-plan deduction for **this** fiscal year, even though the payments will be made later (as we will remind you each month). **TAX TIP:** Even **cash basis** corporations can pay later and still deduct their retirement-plan contributions in this **current** fiscal year. This is the one exception to the rule that only actual **payments** result in tax deductions for cash basis corporations.

**MEDICARE NOTICE:** If you are a new Medicare enrollee, age 65 or older, be aware you **only** have six months from the date of that enrollment, in which to buy the additional private "Medicare Supplement/Medigap" health insurance, without the possibility of rejection—no matter what the condition of your health may be. Similarly, you have the same six-month window of guaranteed insurability upon enrolling in Part B of Medicare, providing you are age 65 or older—no matter when you then first enroll.

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