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How The Audit System Works

For most businesses, the chance of an audit is fairly low. On average, less than 1% of all business returns filed in a given year are audited.

Your audit chances also vary according to the region in which you file your return. This is based on IRS data which indicate that businesses in some parts of the country are more "aggressive" than others in their tax deduction claims. Filing the exact same return in each IRS region can result in a different audit probability as follows:

IRS Region	Audit Percentages
North Atlantic	0.75%
Mid-Atlantic	0.45%
Central	0.65%
Southeastern	0.65%
Southwestern	1.15%
Midwestern	0.68%
Western	1.25%

If one were to break this down into states, the audit percentages would vary even more dramatically. Maine has an average audit probability of .5% while Connecticut businesses have over three times that probability!

Within these income and geographic categories the audit probability will vary according to still more issues, such as certain schedules and deductions taken, types of businesses, specific issues the IRS has chosen to focus on, and how fully staffed the local IRS office is, to name a few.

In general, tax returns are chosen for audit by the IRS DIF program(Discriminant Income Function), which is a highly secretive way of grading various issues on a tax return. Once the computer "scores" the return for this DIF score, an IRS agent then manually reviews these higher scores to decide which ones should be actually audited, and which items should be audited.

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Some "Red Flag" Areas

While the overall DIF function is kept quite secret, there are a number of areas that clearly increase your chance of audit. Some of these are:

Office-in-home deductions
Casualty losses
Bad debt write-offs
IRS perceived "Hobby" businesses with losses
Certain Tax Shelter write-offs
Part-time Sole Proprietorships
Heavy entertainment and miscellaneous business deductions

Does this mean you shouldn't take these deductions out of fear of an audit? Absolutely not. If you are entitled to them, go for it.

However, with any of these "Red Flag" areas, if you are potentially vulnerable to an audit, you can greatly reduce your chances by attaching to the return proof of the substantiation and deductibility of the item in question.

If You Are Audited

There is a great deal of fear by the average business owner in this regard. While an audit is nothing to be taken lightly, it does involve a system that has a number of checks, balances, and rights for the taxpayer. A quick overview of the process is as follows:

The Notice

Usually, your first inkling of an audit comes via the Post Office: a letter from the assigned IRS office and auditor. This letter identifies the tax year in question, a proposed meeting date, and the general scope of the examination. It also includes information on your rights as a taxpayer, one of the most important of which is your right to have representation. In fact, for the vast majority of the audits, you don't even have to attend if you so elect. Instead, you can have a representative go for you.

The Procedure

The auditor will require adequate proof of the deductibility of the items in question, and/or proof of income reported for the business. Usually an auditor will disallow a write-off if you cannot prove the actual expense claimed via a cancelled check and copy of invoice; also, a deduction can be denied "on theory" if you were not entitled to it according to law(a common example would be for casualty losses, or educational expenses, to name a few).

Once the issues are dealt with, the auditor will follow-up the examination with a written report detailing the findings. If there are proposed changes, the report will make the adjustments to the tax return as originally-filed and a tax bill will be sent to you.

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At this point, your options are to agree to the findings, or to fight further on. You can ask for a secondary conference with the original auditor to provide further proof. You can ask for a supervisory review–a talk with the auditor's supervisor. Finally, you can ask for an appeal to a higher level, usually at the Regional Appeals Office. This division's purpose is to "settle out of court." The appeals officer has wide-ranging authority to make decisions and compromises if it is felt that the original auditor may have a weaker case than you do.

In many cases, you have a better chance at this level than not. However, if there were other weak areas on your tax return which were not originally audited, or which the auditor skimmed over in your favor, keep in mind that an Appeals Officer can "re-open" the case, or raise other issues as well. So this must be considered in deciding if an appeal is in order.

Your final option is to take the case to court, either Tax Court, or a Civil Court. In terms of expense, this is frequently the most expensive option to take.

Conclusion

Getting audited is one of the most common taxpayer fears. However, it varies considerably with a number of items. Further, there are a series of protective steps a taxpayer can make to reduce the chance of audit. If audited, there are a number of further steps a taxpayer can take to protect one's rights and preserve one's deductions.

By having a general understanding of what leads to an audit, and how to defend yourself if you are audited, it helps to minimize the potential damage and aggravation in this particularly distasteful part of business taxation.

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