

What are your chances for being audited?

The IRS has issued its annual data book, which provides statistical data on its fiscal 2004 activities. As this letter explains, the tables provide valuable information about how many tax returns IRS examines (audits), as well as data on other enforcement activities, such as collections.

Observation: Overall, audit rates are up slightly for individuals, but down for corporations (except for large ones) and partnerships.

What are the chances of being examined? A total of 1,007,874 individual income tax returns were audited during fiscal year 2004 (Oct. 1, 2003 through Sept. 30, 2004) out of a total of 130.1 million individual returns that were filed in calendar year 2003. This works out to 0.77% of all individual returns that were filed. In the prior fiscal year, 849,296 returns were audited; the audit rate was about 0.65%.

Of the total number of returns audited, 487,461 (48.3%) claimed an earned income tax credit (EITC).

Only 19.3% of the audits were conducted by revenue agents, tax auditors, and tax compliance officers.

Observation: IRS includes in returns examined, examinations by revenue agents, tax auditors, tax compliance officers, as well as correspondence audits.

Observation: IRS does not include in the audit totals computer-matching programs (for example, matching information reported by payors on Forms 1099 against what the taxpayer has reported) and automated error-checking routines that may result in adjustments to tax liabilities, for example, alternative minimum tax liability where no AMT is shown on the return.

The number of individual returns showing total gross receipts from farming (Schedule F) of \$100,000 or more dropped slightly from 2003. However, 4,003 of these returns were audited in 2004 compared to only 2,076 in 2003. Audits of smaller farm operations (under \$100,000 of total gross receipts) also increased significantly, from 1,997 in 2003 to 3,104 in 2004.

Year-over-year, the number of corporations (including S corporations) audited dropped by almost 25%, from 30,700 in 2003 to 23,499 in 2004. Only 0.32% of small corporations (assets under \$10 million) were audited; for 2003, the audit rate was 0.58%. For large corporations (assets of \$10 million or more), the audit rate increased to 16.74% from 12.08% in 2003. For S corporations, the audit rate was 0.19%, down from 0.30% in 2003.

Audits of estate tax returns dropped from 7,265 to 6,402. However, because the number of estate returns filed dropped by 23.5% year-over-year, the actual audit rate increased from 6.38% to 7.41%. The audit coverage rate for gift tax returns increased slightly, from 0.66% to 0.69%.

Observation: The significant reduction in the number of estate tax returns filed is probably

due in large part to the increase in the applicable exclusion amount, from \$1 million for estates of decedents dying in 2003 to \$1.5 million for 2004 decedents.

The following table shows the chances of being examined in fiscal year 2004 as compared to fiscal year 2003. The figures include correspondence examinations, office examinations and field examinations. The data is classified by types and amounts of income, type of returns, etc. The percentage of returns examined is shown separately for each category based on the number of returns filed in that category in the preceding year (i.e., number of returns audited in fiscal 2004 versus number of returns filed in calendar 2003).

	Percentage of returns audited	
	2004	2003
Individuals--Nonbusiness (based on total positive income (TPI))		
Under \$25,000 (1040A)	0.50%	0.51%
All other returns by size of TPI		
Under \$25,000	1.26	1.09
\$25,000 to under \$50,000	0.43	0.30
\$50,000 to under \$100,000	0.44	0.41
\$100,000 and over	1.39	0.98
Individuals filing Schedule C showing gross receipts as indicated		
Under \$25,000	3.15	3.00
\$25,000 to under \$100,000	1.47	1.33
\$100,000 and over	1.86	1.47
Individuals filing Schedule F showing gross receipts as indicated		
Under \$100,000	0.91	0.57
\$100,000 and over	1.61	0.78
Fiduciary (Estate and Trust Income)	0.12	0.17
Corporations (based on assets)		
Under \$10,000,000	0.32	0.58
\$10,000,000 and over	16.74	12.08
S Corporations	0.19	0.30
Partnerships	0.26	0.35
Estate tax	7.41	6.38
Gift tax	0.69	0.66

Observation: Year-over-year, audit rates in 2004 rose in all categories of individual returns except for Form 1040A filers with under \$25,000 TPI. However, audit coverage is lower than a decade ago. For example, the overall audit rate in '93 was 0.92%. In the '80s, the audit rate was typically about 2%.

IRS activity on other fronts. Here's a roundup of other valuable information carried in the new IRS Data Book.

Penalties. In fiscal 2004, IRS assessed 18.8 million civil penalties against individual taxpayers. Of these, 11.0 million (58.6%) were for failure to pay, followed by 5.2 million for underpayment of estimated tax, and 2.3 million for delinquency. There were only 225 negligence penalties assessed against individuals relating to income tax.

On the corporation side, there were a total of 660,000 penalty assessments, 82% for either failure to pay or underpayment of estimated tax. The tables indicate 25 negligence penalties assessed for corporation income tax.

Offers in compromise. In fiscal 2004, 106,000 offers in compromise were received by IRS, and 20,000 (18.9%) were accepted. Over recent years, these numbers have been dropping; in 2001, 125,000 offers were submitted and 39,000 (31.2%) accepted.

Information returns. IRS received a total of 1.39 billion information returns in fiscal 2004, including Forms 1098 (mortgage interest, student loan interest, and tuition), 1099 (interest, dividends, etc.), W-2 (wages), W-2G (gambling winnings), and Schedules K-1 (pass-through entities). Of the total, only 3.2% were submitted on paper. Most of the information returns were filed electronically or on magnetic tape.

If you have any questions about the above information and how it affects you personal tax situation, please give me a call.

Cordially

John K. Ross IV

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