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No more Mr. Nice Guy: IRS swoops in for audits

By Sandra Block, USA TODAY

Determined to stop a troubling rise in tax fraud, the IRS is scrutinizing more returns, shutting down tax shelters and frog marching scofflaws into court.

So as you hustle to file your 1040 before midnight Friday, should you worry about an audit?

If you're a middle-income wage earner with a straightforward tax return, probably not. But if you're wealthy, self-employed or have had your returns prepared by an unorthodox tax adviser, keep good records. The IRS may want to chat with you. (**Related story:** [IRS plans to close 105 walk-in assistance centers](#))

For the past year, IRS Commissioner Mark Everson has been barnstorming the country, telling journalists, politicians and tax professionals that the nation's tax cops are back on the beat. The number of audits rose nearly 19% last year. Audits of high-income taxpayers rose 40%. In February, the Justice Department and the IRS indicted telecommunications entrepreneur Walter Anderson for allegedly failing to pay \$200 million in federal and local taxes, the largest criminal tax case against an individual.

At a time of rising federal budget deficits, there are powerful incentives to toughen tax enforcement. An IRS study released last month estimates that the "tax gap" — the difference between the amount taxpayers owe and the amount they actually pay, is \$312 billion to \$353 billion a year.

But the study also found that workers who have taxes withheld from their paychecks are the least likely to cheat. Less than 1.5% of wages and salaries subject to third-party reporting or withholding are incorrectly reported, the study found.

Kathleen Pedersen, 46, of Anchorage says her father was a tax attorney and "always made us aware of the possibility of an audit." She waited until the last minute to file, and her tax returns are more complicated than usual this year because she and her husband sold two homes in 2004. But Pedersen, who uses TurboTax software to prepare her family's taxes, isn't worried about being audited by the IRS. "I'm confident that if we were, we've got the information" to answer the IRS' questions, she says.

Among the likely candidates for an IRS audit:

•**Wealthy taxpayers with big losses on their returns.** The IRS has launched a major assault on tax shelters marketed to wealthy taxpayers. It has collected more than \$3.2 billion from the so-called "Son of Boss" shelter, which used currency options and other financial products to create fictitious losses. Participants used the losses to avoid paying taxes on sales of stock options or business assets.

Amounts collected from individual taxpayers who bought into the shelters ranged from \$1 million to more than \$100 million, the IRS said.

The shelters were created because tax professionals thought they could get away with it, says Scott Michel, partner with Caplin & Drysdale and former chairman of the American Bar Association's committee on civil and criminal tax penalties. Now, tax professionals will be much less likely to recommend aggressive tax-avoidance strategies, he predicts.

More tax-shelter cases are probably in the works, tax experts say. "The people who should be most concerned are those who entered into transactions that sounded too good to be true," says David Sands, chairman of the New York State Society of CPAs' IRS tax committee.

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•**Unscrupulous tax preparers and their clients.** The IRS and the Justice Department have aggressively pursued tax preparers who use fictitious deductions and other scams to inflate their clients' refunds. The IRS obtained 117 criminal convictions of tax preparers in fiscal 2004, up from 67 in 2003.

In January, the agency issued a press release that included names of preparers who had been convicted of filing false tax returns. "I don't recall seeing them do that before," says Mel Schwarz, federal tax director for accounting firm Grant Thornton.

A tax preparer's conviction can have far-reaching consequences. Typically, the IRS goes back and reviews all returns filed by the preparer's clients. Those individuals are liable for interest and penalties on unpaid taxes, sometimes going back years.

And unlike with tax shelters, the clients aren't always wealthy. A frequent source of tax-preparer fraud is the earned income tax credit, designed to help the working poor. Unscrupulous preparers urge taxpayers to hide income or invent fictitious dependents to inflate the size of their credits.

More than 70% of taxpayers who claim the earned income credit use tax preparers, yet they're still audited at a much higher rate than others, says Janet Spragens, a law professor at American University in Washington, D.C. Spragens, who directs a free tax clinic for low-income taxpayers, says many non-English-speaking taxpayers seek out preparers who speak their language, without checking their credentials or training. "The advice they get from these preparers can range from excellent to incompetent to totally fraudulent," Spragens testified at a recent IRS oversight board hearing.

•**The self-employed.** Nearly 9.5 million workers were self-employed in 2004, up 22% from a decade earlier. The number of self-employed workers and independent contractors is expected to keep growing as companies seek to reduce benefit costs associated with full-time employees. But unlike wage-earners, the self-employed are responsible for reporting their income to the IRS. The IRS study found that underreported income accounted for 80% of the tax gap.

Taxpayers who file a Schedule C, the form used to report profits and losses from a business, should expect more scrutiny from the IRS. In 2005, the IRS expects to audit 207,000 Schedule C returns, up 50% since 2002, says Kevin Brown, commissioner of the IRS' small business/self-employed division.

That prospect unnerves Michelle Wicks, 35, owner of Michelle's of New York, a plus-size women's boutique in Islip Terrace, N.Y. Wicks started her business last April and is a sole proprietor, which means she's required to file Schedule C.

Wicks has done her own taxes since she was 22, but she found Schedule C so confusing that she called the IRS several times with questions. Some IRS employees were helpful, others weren't, and one hung up on her, she says. Wicks has kept meticulous records in case her return triggers an audit. "I'm excited about my store, but this part of it is very scary," she says.

The IRS is also paying more attention to the status of independent contractors, says Jeff Phelps, chief operating officer of ABE Services, a Sonoma, Calif.-based consulting firm. The IRS uses a complicated test to determine whether an individual is a contractor or employee, Phelps says. If it determines an individual is misclassified, the employer could face steep penalties and back taxes, and the worker could lose valuable self-employment deductions, he says.

Enforcement obstacles

For all its talk about chasing down the bad guys, the IRS enforcement initiative faces obstacles. Among them:

•**Money.** President Bush's 2006 budget requests an additional \$500 million to strengthen the IRS enforcement program. Sounds impressive, but it's not enough, says Charles Rossotti, head of the IRS from 1997 to 2002 and author of *Many Unhappy Returns: One Man's Quest to Turn Around the Most Unpopular Organization in America*. This proposed increase, like past budget hikes, probably will be eaten up by congressionally mandated pay raises for federal employees, Rossotti says.

The IRS has 15,000 fewer workers than it had 10 years ago, Rossotti says. During the same period, the economy has grown significantly and is much more complex. "There just aren't enough resources to even tackle the most serious abusers," he says.

•**Perplexity.** Beefing up enforcement efforts will require the IRS to enforce tax laws that are increasingly difficult for law-abiding taxpayers to obey.

Eric Delore of Alameda, Calif., owes the IRS more than \$400,000. He didn't participate in a tax shelter or invent illegal deductions for a home-based business. Delore, a technology professional, is in debt because he received incentive stock options from his former employer. Those options pushed him into the nightmare world of the alternative minimum tax.

The AMT originally was created to prevent wealthy individuals from using loopholes to avoid paying taxes, but it's increasingly affecting middle-income taxpayers. Taxpayers who live in high-tax states or receive incentive stock options are particularly vulnerable.

In 2000, Delore exercised stock options worth \$1.1 million and held on to them so he could get a better tax rate when he sold. But his employer's stock price imploded when the tech bubble burst. By the time Delore sold his shares, they were worth \$5,000. But because the AMT values stock options at the time of exercise, Delore was hit with a \$420,000 tax bill.

In 2001, Delore's employer filed for bankruptcy, and he lost his job. He's now working for a software company, but his struggles with the IRS continue. His bank accounts have been cleaned out and his paycheck intercepted. There's a lien on his house. He's tried twice to negotiate a lower tax bill with the IRS but was rejected both times. If the IRS rejects his latest offer, Delore, who is married and has two small children, says he'll be forced to file for bankruptcy protection.

At a speech in February before the National Press Club, Everson said tax complexity "compromises both the service and enforcement missions of the IRS." Bush has named a bipartisan tax panel to study tax simplification. In the meantime, the number of taxpayers subject to the AMT continues to grow. More than 3 million will pay it this year.

Delore now believes he took a big risk when he told the IRS that he exercised his options. He says horror stories like his encourage taxpayers to break the law. The government "should make compliance easier," he says. "Then you'll get more people paying their taxes."

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