

# Examination & Audits

## 1. Selection of Returns for Examination

- a) IRS tries to promote the highest degree of voluntary compliance. To accomplish this in an effective manner, the process of classification is used to determine which returns are most in need of examination. However, because of resource limitations, not all the computer classified returns are examined.
- b) Tax returns are classified and selected for examination by computer or by manual identification. Returns that are classified by computer as having examination potential. Then may be manually screened to identify issues for consideration and set the scope of the examination.
- c) The Discriminant Function (DIP) system is a mathematical technique used for identifying and selecting returns for examination. Under DIF system, mathematical formulas are developed and programmed into the computer to identify returns by assigning weights to certain basic return characteristics. The weights are then added together to produce a score for each return processed.
- d) Returns are then ranked in numerical sequence based on their score (highest to lowest). Generally, the higher the score the greater the likelihood of a significant tax change on examination.
- e) The DIP mathematical formulas are confidential in nature. Similarly, DIP score for a return should not be disclosed.
- f) Examinations may be initiated by the IRS other IRS examinations or programs, e.g., matching information documents or by specific IRS compliance programs.
- g) The filing of certain forms, for example, Form 8283, or Form 8082 (Notice of Inconsistent Treatment), or the filing of a tax-shelter return, is likely to result in the selection of a return for examination.

## 2. Individual Audits

- a) For most easy cases, IRS sends an initial contact letter requesting, or explaining corrections to the return. If the taxpayer agrees to a correction, then the case is closed. Otherwise, a notice of deficiency, 30-Day Letter, will be issued. If the taxpayer fails to respond to the 30- Day Letter, then, a statutory notice of deficiency, 90-Day Letter, is issued at the expiration of the 60-day period.

- b) For most field audit cases, for all large, unusual, or questionable items, a package examination should be followed, including consideration of prior and subsequent returns and all related returns.
- c) The audit issues should be examined to the extent necessary to provide sufficient information to determine the substantially correct tax, including conduct adequate interviews and check the proof of payments.
- d) What IRS looking for are: (1) the comparative size of the item, e.g., the item of **\$6,000 / \$30,000** would be significant; (2) the absolute size of imbalance; (3) inherent character of the item, e.g., airplane expenses claimed on a plumber's Schedule C; (4) the evidence of intent to mislead or incomplete schedules.

### **3. Chances of being audited**

- a) In 2010, of the 142,823,105 total individual income tax returns, 1,581,394 were audited. This is about 1.1 %.
- b) Of the total number of individual income tax returns audited in 2010, 473,999 returns, about 30% were for returns with EIC claim.
- c) For individuals not claiming the EIC,
  - (1) For business returns, Schedule C, showing total gross receipts of \$100,000 to \$200,000, about 4.7% of returns were audited in 2010.
  - (2) For business returns showing total gross receipts of \$200,000 or more, about 3.3% of returns were audited in 2010.
  - (3) For 2010, the audit rate for business returns with total positive income of \$1 million or more was 8.4%.
- d) The audit rates for business returns were as follow:
  - (1) For all corporate returns other than Form 1120S was 1.4%
  - (2) For Form 1120 with total assets of \$250,000 to \$1M was 1.4%
  - (3) For Form 1120 with total assets of \$1 - \$5M is 1.7% and \$5 –\$10M was 3%
  - (4) For Form 1120 with total assets of \$10 or more was 16.6%
  - (5) For Form 1120S & Form 1065 was 0.4%