Recently, the Internal Revenue Service released its audit rates for 2007. But, before the IRS' recent release of information is examined, permit me to issue a word of caution: any of your clients who might be aware of these numbers should be discouraged from interpreting them to mean that the chance of being audited by the IRS is so low that they can be cavalier about their tax reporting obligations. Anyone required to file a federal income tax return is required to report all of their income AND to keep records sufficiently adequate to file a correct tax return. Willful disregard of these obligations can have serious repercussions and your clients ought to be told this.

The top income tax audit targets remain small businesses, as the IRS estimates that failure to report business income on individual returns is responsible for 43% ($148 billion) of what is believed to be the total current "tax gap" of $345 billion. That figure is the total amount of income taxes the IRS believes is owed but it is not collecting. One of the interesting aspects of the recent audit rates is how a small business is legally organized greatly affects its chances of being audited. For 2007, proprietorships, those businesses reporting business activity on a Schedule "C" attached to the owner's Form 1040, had audit rates dependent upon their gross receipts. The audit rate was 1.3% (of every 1000 returns, 13 were subject to audit) for Schedule "C" returns showing less than $25,000; 2% for returns showing $25,000 to $100,000; 6.2% for returns showing $100,000 to $200,000; and 1.9% for returns showing more than $200,000.

Contrast these numbers with all subchapter "S" corporations, which were audited at only a 0.5% rate (5 returns per 1000 filed); and all partnership returns which were audited at just a 0.4% rate. The IRS noted that overall audit rates for "S" corps and partnerships were related to total assets and not to gross receipts levels. The clear planning opportunity is to utilize one of the corporate entities, or a limited liability company, not to only reduce the likelihood of facing an IRS audit, but also to gain liability protection and the tax advantages that these entities offer. Accordingly, it appears there is little justification today to advise a client to conduct any business as a sole proprietorship.

Regular "C" corporations also have a lower audit risk in 2007 than did proprietorships, except for very large corporations. Regular corporations with balance sheets assets below $250,000 faced an audit risk of just 0.8% (8 returns per 1000 filed), but firms with balance sheet assets from $1,000,000 to $5,000,000 had a risk of 1.7%, and firms with assets from $5,000,000 to $10,000,000 had a risk of 3%. Only corporations with balance sheets assets in excess of $10,000,000 had an audit risk higher than proprietorships, with an average audit risk rate of 16.8%. Although that rate is a lot higher than the other risk rates, it is still less than one in five.

In the estate and gift tax area, the IRS numbers show it is safer, audit risk wise, to transfer assets by gift rather than leaving them in your estate. Gift tax returns were audited at the slight rate of 0.8%, or only 8 returns for every 1000 filed. But the overall audit rate for Form 706, the United States Estate Tax Return, was 9.7%. And, estates with assets of more than $5,000,000 had an audit rate of 23.4%. Take note, although the recent IRS release did not specifically address this point, it has been my experience that ***all*** large estates are audited. I don't know the "magic number," but if your client's estate is above $15,000,000, make sure the estate planning strategies are sound and that the documents are proper, because the IRS will probably be taking a close look.

Lastly, the IRS release notes the audit rate for all individual returns was 1.03% in 2007, and the agency is trumpeting how that was the highest rate in about 10 years. It is also about double the all-time low rate of 0.49%, experienced in 2000. However, the reality of these individual numbers is that IRS' highly successful correspondence audit program is included. A correspondence audit is a process via which the entire matter is handled through the mail. I think most taxpayers consider a "real" audit to be one in which they are required to sit across a desk from an IRS tax examiner. These face-to-face audits took place in 2007 at just a 0.23% rate, barely above the office audit rate in 2000 of 0.20%.

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