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HOW TO AVOID IRS AUDITS IN 2011

PART 2 - INCOME

By Victor S. Sy, CPA

Taxpayers who get aggressive with tax deductions or try to hide income are solving a problem with a bigger tax problem - IRS audits. Dealing with the IRS is not amusing. It's a nightmare! Stress levels rise. Your otherwise comfortable world gets turned upside down. We discussed general tips to stay under IRS radar in our prior newsletter. Let's discuss **10 income issues** in this article and deductions in the next one.

1. **Report all income.** IRS receives copies of 1099s and W2s from your work, bank, buyers, people who pay you. To miss a 1099 is flirting with IRS scrutiny.
2. If you are missing a W-2 from an employer who moved or closed shop, use Form 4852. Use your last pay stub that shows year-to-date earnings and withholdings to complete Form 4852 and attach it to the front of your return.
3. If you **misplace or do not receive a 1099**, report your income anyway; otherwise, you'll get a notice of unreported income. It could start an examination if the Service finds more flags in your tax return. The trick to avoiding IRS notices for unreported income is to **report all 1099s** under your Social Security Number - right or wrong. If wrong, report the amount and back it out with an explanation. Failure to report it will generate IRS notice CP-2000 that can spell trouble if there are other "interesting" items on your return.
4. If you are **missing a 1099 for stock sales**, request from your broker a year-end statement that summarizes your dividend income, interest income, and sales of stocks. Some brokers do not provide basis (cost) of stocks that you bought. Instead, they ask you to "consult your accountant" - a typical excuse for inefficient operations. They already have your cost in their data base files, but do not provide it to you until you complain. TIP: Do not forget to reduce your gains by dividends that were reinvested to buy more stocks or by stock splits and broker commissions. Every little thing helps save taxes.
5. Money that you receive "**under the table**" may not be as safe as you think. The payer may make a deal with you not to report the transaction, but what makes you think that his/her accountant will go along with that? I wouldn't. Company owners complain of paying too much taxes to accountants who make ways to save taxes - especially amounts paid "under the table" without regard to whatever promises may have been made to you.
6. Then there's the issue of **forgiven debt** - a sign of the times. If you owe \$10,000 to MasterCard which agreed to accept \$6,000, that \$4,000 debt relief is income to you. The company will issue you a 1099-COD (Cancellation of Debt) which you must report as ordinary income (not capital gain).
7. **Forgiven debt on your main residence** is another issue. Please refer to a separate article on how to exclude debt relief from the foreclosure or short sale of your residence at my website of www.victorsycpa.com. Look for a newsletter on "Home Sale - Exclusion of Gain."
8. If you convert your **hobby** into a business, be careful about taking losses. Hobby losses are not deductible. You become a candidate for audit if you report this activity in Schedule C and become a prime candidate if you show losses. Read "Hobby Loss Rules" at www.victorsycpa.com.
9. If you are a small business owner who files **Schedule C** (Income from Business or Profession) - beware. You are at the top of the food chain for IRS consumption. Majority of audit cases that we handle come from Schedule Cs. Why? IRS studies point out that a big chunk of the "tax gap" can be traced to sole proprietors. The government's chances of collecting taxes, penalties, and interest from Schedule C audits are higher than the rest of the population, that's why.
10. Categories of **cash-intensive businesses** such as retailers and contractors lead the pack of candidates for audits.