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# Scoring points for your financial future

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

Will your return be one of those under intense scrutiny?

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.

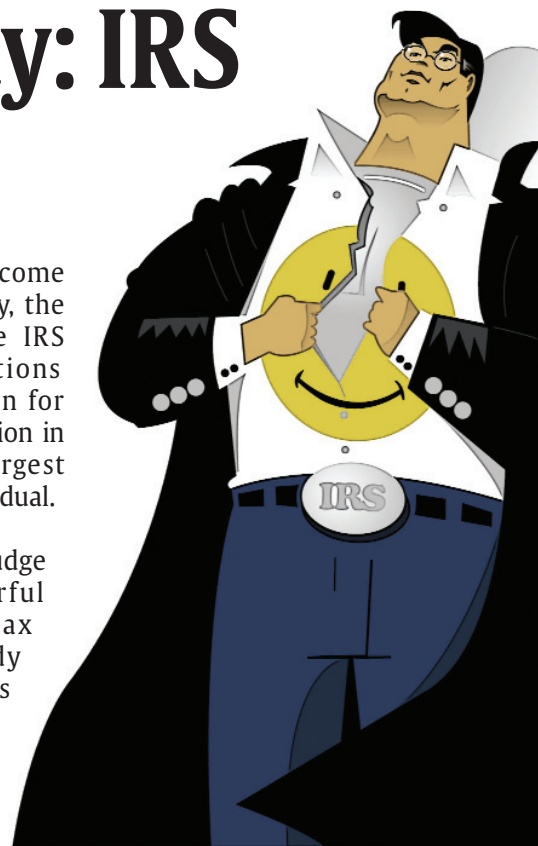
For the past year, IRS Commissioner Mark Everson has been barnstorming the country, telling journalists, politicians and tax professionals that the nation's tax cops are back on the beat. The number of audits rose nearly

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



By Keith Simmons, USA TODAY

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:

Presented by:



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► **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.

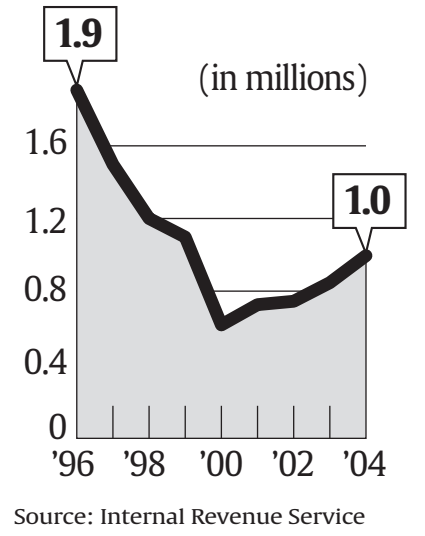
More tax-shelter cases are probably in the works, tax experts say. "The people who should be most concerned are those who entered into transactions that sounded too good to be true," says David Sands, chairman of the New York State Society of CPAs' IRS tax committee.

► **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

### Audits on the rise

IRS audits of individual taxpayers are rising but still way down from 1996. Fiscal year audits:



By Adrienne Lewis, USA TODAY

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."

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

### Objectives:

Students will:

- read and discuss the USA TODAY article, “No more Mr. Nice Guy: IRS swoops in for audits.”
- discuss tax fraud, tax collection methods and the reasons that the government collects taxes.
- define and provide examples of different types of taxes.

### Concepts:

- audits
- income taxes
- IRS
- tax fraud
- tax gap
- tax shelters

### Instructions:

1. Give each student a copy of the article, “No more Mr. Nice Guy: IRS swoops in for audits,” along with the attached discussion questions and graphic organizer.
2. Divide students into pairs, and ask them to read the article silently. Then, have student pairs discuss each question and jot their answers on a sheet of paper.
3. Next, have each pair complete the activity and accompanying graphic organizer.
4. Post-reading: If time permits, ask students to complete the Snapshot activity on the origins of taxes.

### Activity at a glance:

- Grade level: 7-10
- Subjects: government, social studies, personal finance, knowledge
- Estimated time for this activity: 60-90 minutes

### Materials:

- Reading: “No more Mr. Nice Guy: IRS swoops in for audits”
- Copy of discussion questions and activity
- Graphic organizer, “Understanding taxes”
- Glossary and Snapshot worksheet
- Internet access

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

### Discussion:

What steps is the IRS taking to quell rising incidents of tax fraud? Which tax filers are most likely to be flagged by the IRS? What incentives are being used to toughen federal tax enforcement? How is the “tax gap” defined?

According to an IRS study, which taxpayers are least likely to cheat on their returns? Why is the IRS targeting tax shelters in their audits? How does the “Son of Boss” shelter defraud the government of tax revenue? Why do some accountants recommend aggressive tax-avoidance strategies? How does the IRS deal with unscrupulous tax preparers? What consequences can tax preparers face for such actions?

What enforcement obstacles does the IRS face? Identify three solutions that would make paying and collecting taxes easier. Discuss the pros and cons of each.

### Activity:

Income taxes are taxes on salaries, tips, bonuses, interest and other dividends. Property taxes are taxes on real estate, automobiles, boats, recreational vehicles and business inventories. Define the following taxes: business tax, excise tax, payroll tax, progressive tax, regressive tax, sales tax. Then, identify examples of each type of tax. Use the attached graphic organizer “Understanding taxes” to organize the information. Do outside research, as necessary, to help you fill in your chart.

### Additional resource:

- The Internal Revenue Service has a website specifically designed to answer students’ questions about taxes. For more information about filing, refunds, and other tax-related topics, visit [www.irs.gov/individuals/students/index.html](http://www.irs.gov/individuals/students/index.html).

### Activity extensions:

- A flat-rate federal income tax proposes that all Americans be taxed at the same rate, e.g., 17%. At this rate, how much would a person who earns \$37,000 per year pay in federal income taxes? How much would someone who earns \$250,000 pay? Now, argue in favor or against adopting a flat-rate tax, and cite three facts, statistics or other data to support your position.
- Income taxes are used to fund public schools, police and fire departments, public works projects and countless other civic proposals. As a class, list as many of these as you can think of. Then, decide which are necessary and which are extravagant expenditures. Explain the basis for each choice.

# Understanding taxes

Type of tax	Definition	Examples
Income	Taxes on income, both earned and unearned. Income taxes can be levied both on individuals and businesses.	Earned: salaries, wages, tips, commissions, bonuses Unearned: interest and dividends.
Property		
Business		
Excise		
Payroll		
Progressive		
Regressive		
Sales		

## Glossary\*

- ▶ Business taxes – Taxes levied on business by federal, state or local governments. These include (in addition to corporate income taxes on earnings and profits) unemployment insurance, worker’s compensation, contributions to Social Security and Medicare insurance.
- ▶ Excise taxes – Taxes on the sale or use of specific products or transactions.
- ▶ Earned income – Includes wages, salaries, tips and net earnings from self-employment and other income received for personal services.
- ▶ Income taxes – Taxes on income, both earned (e.g., salaries, wages, tips, commissions) and unearned (e.g., interest and dividends). Income taxes can be levied on both individuals (personal income tax) and businesses (business and corporate income taxes.)
- ▶ Payroll taxes – Taxes collected from employers and employees to finance specific programs; levied on earned income, such as wages, salaries and self-employment earnings.
- ▶ Progressive taxes – A tax that takes a larger percentage from high-income groups than from low income groups.
- ▶ Property taxes – Taxes on property, especially real estate. They can also be levied on boats, automobiles (often paid along with license fees) recreational vehicles and business inventories.
- ▶ Regressive taxes – A tax that takes a larger percentage of income from low-income groups than from high-income groups.
- ▶ Sales taxes – Taxes on retail products, based on a set percentage of retail cost.
- ▶ Unearned income – Income other than pay for work performed. Interest and dividends from savings or investments are common types of unearned income.

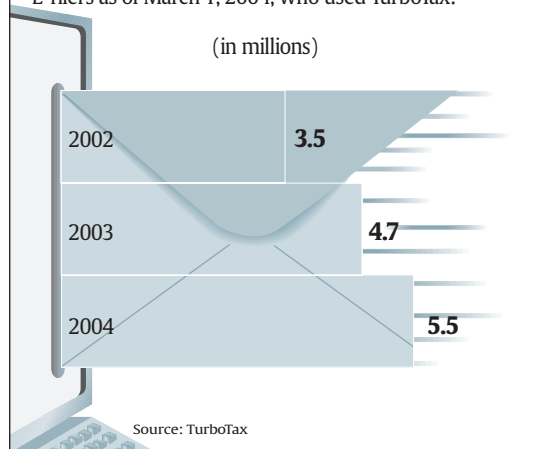
\*Source: Internal Revenue Service

## Snapshot

### USA TODAY Snapshots®

#### Filing taxes online continues to climb

E-filers as of March 1, 2004, who used TurboTax:



By Shannon Reilly and Adrienne Lewis, USA TODAY

**APPLICATIONS:** *government, history, social studies, knowledge, research*

**What are the advantages and disadvantages of filing your taxes electronically? Why do you think more and more people are going online to file their taxes?**

Benjamin Franklin once said that the only things certain in life are “death and taxes.” How much do you know about the Internal Revenue Service? For starters, it is the nation’s tax collection agency and it administers the Internal Revenue Code enacted by Congress. The agency

dates back to the Civil War when President Lincoln and Congress, in 1862, created the Commissioner of Internal Revenue and enacted an income tax to pay war expenses. The income tax was repealed 10 years later. In 1913, the states ratified the 16th Amendment, which gave Congress the authority to enact an income tax. \*

Identify another tax, and through research, explain its origins. Report your findings back to the class.

\*Source: Internal Revenue Service