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Newsletter Article Reprint

IRS Announces New Audit Targets and Revival of Random Tax Audits

By John K. McGill, M.B.A., J.D., CPA. and courtesy of The McGill Advisory

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IRS audit rates have been rising recently. Moreover, the IRS is targeting its audits more effectively than ever before. Below are the most dangerous areas of audit risk for doctors now.

1. Unincorporated Doctors

IRS research shows that sole proprietors underpay their taxes by far more than any other group. For example, small business sole proprietors underpaid their taxes by a total of $68 billion in 2001, compared to only $30 billion for all large corporations. As a result, the IRS plans to increase its scrutiny of sole proprietors filing Schedule C. Accordingly, doctors operating as unincorporated sole proprietors face the highest audit risk.

2. Salary Levels for S Corporation Doctors

The salary of a doctor operating as an S corporation must be “reasonable” compared to the work done. Some doctors have paid themselves very little salaries (even zero), taking all of their practice profits as a dividend to avoid payroll taxes. Unreasonably low salary levels are a“red flag” to the IRS. To be on the safe side, doctors should draw a salary equal to the greater of $230,000, or 25% of their total collections, with the balance of practice profits paid out as a dividend.

3. Salaries for C Corporation Doctors

The IRS plans to review C corporation tax returns where doctors pay out all of their practice profits in the form of salaries to themselves so to avoid double taxation (first on corporate profits, second as dividend income on the personal return).

4. Capital Gains Taxes

IRS officials suspect the government is losing billions of dollars in tax revenue annually because some doctors and other investors purposely inflate the cost basis that they paid for stocks and real estate sold. This results in reporting lower capital gains when these assets are sold, decreasing the tax revenue received.

5. Whole Life Insurance Schemes

The IRS recently issued two notices (2007-83 and 2007-84) indicating plans to increase audits of doctors who attempt to deduct premiums on cash value life insurance policies held inside a VEBA or Section 4 19(e) trust arrangement. Fortunately, doctors already have the ability to increase savings on a tax-deductible basis through contributions to qualified retirement and defined benefit plans.

Random Tax Audits Revived

The IRS also recently announced plans to revive its controversial practice of randomly targeting thousands of taxpayers for audits, even when the agency has no reason to suspect them of wrongdoing. IRS officials expect these random audits to provide fresh data to help update the top secret formulas the agency uses to select tax returns for audit, and thus improve their job of combating tax evasion. These audits come at a time when the IRS faces increasing pressure to take bolder action to slash the “tax gap”, the difference between what the government collects each year and what it should be collecting. The IRS estimates that the tax gap now stands at $290 billion annually.

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