

from Chuck's Desk

Accounting

Income Taxes

Business Consulting

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I welcome any comments or
suggestions you may have.

Please call or e-mail me
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Chuck Donovan

The Tax System's Built-In Fear Factor – An IRS Audit



Psychologists say the fear of an unpleasant event can often be more traumatic and disruptive than the actual event. Most taxpayers would prefer to undergo a root canal than an IRS audit. The mere thought of a telephone call from, a letter from, or a meeting with the IRS frightens us.

The IRS audits between 2% to 3% of all tax returns filed each year. Since about 130 million are filed annually, they will review around 4 million of them.

Will I Be Audited?

"Will I be audited?" is a question I am asked a lot each year.

Well, it depends. As soon as tax returns come in, the IRS checks them for accuracy. Then a computer program compares them against average return models and flags uncommon items such as high income, large or unusual deductions, self-employment expenses, and unusual types of businesses. Returns could be selected at this stage for review, examination or audit based on the number of flagged items.

Moreover the IRS has very specific methods for handling the returns they receive.

The Differential Income Factor Method (DIF)

DIF is a mathematical technique used to score individual, corporation, S corporation, and partnership returns as to examination potential. Each receives a DIF score based on the amount of income reported and deductions claimed. Basically, the higher deductions are relative to income, the higher the DIF score will be and the greater is the possibility a return will be looked at. For example, if you report income of \$50,000 and claim medical expenses of \$8,000 or mortgage interest of \$14,000, you will have a higher DIF score than a taxpayer with the same income who claimed only \$4,000 in medical expenses or \$7,000 in mortgage interest.

When the score exceeds a particular threshold for the reported income, the return would be an audit candidate.

The Information Returns Factor Method

The IRS records the social security numbers from all W-2s and 1099s filed every year and matches them to the social security numbers on tax returns. If you received \$1,000 in interest from a bank but reported only \$500 on your return, it will be caught based on your social security number. As a result, getting a notice from the IRS should not be a surprise to you.



Affordable Business Services, a full service accounting firm, offers innovative business solutions to small and medium size companies through specializing in the training, and consulting in the use of QuickBooks business management software.

Chuck Donovan MBA brings over 20 years of financial expertise to the business having worked as a senior financial executive with firms ranging in size from \$20 million to \$3 billion in sales.

His broad, hands-on accounting and finance experience has taught him that financial information must be more than just a series of numbers.

He shows and helps business owners to use their financial information to increase their cash flows, improve their profits, and build their companies, so they can plan for a secure future.

A QuickBooks Professional Advisor and experienced problem solver, Chuck is a graduate of Dartmouth College and received his MBA from American International College.

The Random Selection Method

You may be selected at random. Simply stated, you got "lucky". All returns are entered into a computer random number selector. Those with high DIFs and non-matched information are eliminated. Then a certain number are picked randomly to make sure about 4 million returns are audited annually.

Types of Audits

The IRS performs essentially two types of audits.

1. A Correspondence Audit in which they send a taxpayer a letter requesting additional information. For example, the total of the 1099s issued to the taxpayer does not match the income reported on the return.
2. A Field Audit is one in which an auditor comes to your place and reviews your records.

Who Gets Audited

Individuals making \$100,000 or more and those making \$25,000 or less are much more likely to face an audit than those with income in between. The IRS seeks out returns with a high probability of generating more revenue.

High income taxpayers have generally more complicated returns with more opportunities to hide income or create deductions. Although the low income people have usually simple returns, many claim earned income tax credit, a low income refund program on which the IRS has focused to cut down on mistakes and fraud.

Since the IRS looks for returns with a high probability of generating more revenue, not only is income a consideration but also such factors as self-employment and profession. People working in industries where they receive much of their income in cash are popular audit candidates.

This includes waiters, gaming industry workers, dentists, and doctors. The bottom line is the more cash received and the higher the income potential, the more likely the IRS will find additional tax dollars by reviewing the returns.

I hope you do not get the feeling after reading this that everything is hopeless. For all taxpayers the audit rate in 2001 was .58 percent, slightly higher than 2000 but much lower than the years before 2000. The reason is that the 1998 tax reform law has attempted to make the IRS friendly to taxpayers.



Where to Order Your Credit Report

I received many favorable comments on "When Did You Last Check Your Credit Report" which appeared in the Spring edition of **from Chuck's Desk**. However, several people mentioned that the story did not contain information on where to obtain a credit report. They would have liked to have seen that information discussed in the story. It was an oversight on my part and I apologize for it.

You can order a copy of your credit report from:

- **Experian
National Consumer Assistance Center
PO Box 2002
Allen, TX 75013**

Telephone: 1 800 311-4769

The cost is \$9.00 unless you have been denied credit. In which case the report is free and can be ordered by telephone. Otherwise the report has to be ordered by mail or over their web site www.experian.com.



- **Equifax Information Services, LLC**
P.O. Box 740241
Atlanta, GA 30374

Telephone: 1-800-685-1111

The cost is \$9.00 unless you have been denied credit. In which case the report is free and can be ordered by telephone or over their web site www.econsumer.equifax.com.

- **TransUnion LLC**
Consumer Disclosure Center
P.O. Box 1000
Chester, PA 19022

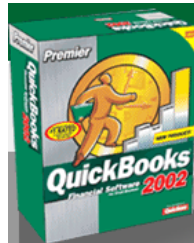
Telephone: 1- 800-888-4213

The cost is \$9.00 unless you have been denied credit. In which case the report is free and can be ordered by telephone. Otherwise the report has to be ordered by mail or over their web site www.transunion.com.

QUICKBOOKS® Notes

Continuing its additions to its product lines, Intuit has announced two new software packages recently.

The first is **QuickBooks Enterprise Solutions**. It includes all the features of QuickBooks Premier 2002 edition, allows up to 10 users to work simultaneously, has the capacity for almost 30,000 customers, products, and vendors, provides better tracking and managing of more employee information, and expands the tracking of sales orders and back orders.



The second is **QuickBooks Point of Sale**. Retailers can ring up sales faster, track inventory and run reports in minutes, and process credit card purchases. It can be used as a stand-alone product, but QuickBooks Pro 2002 or Premier 2002 is required for data exchange with the Point of Sale software.

The company has recognized that there are other users within the marketplace that need specific software to meet their business needs and is offering these products to satisfy the requirements of each of these groups. It has also finally acknowledged that upgrade options are needed to meet the needs of customers who have outgrown the capacity of the basic QuickBooks editions.