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From this week's Focus

The Tax Man muscled up: More audits loom

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David Stafseth, a CPA at Vogel Consulting LLC, says that the IRS has been "dedicated to reducing" tax evasion. Photo by: Erik Unger

Almost every federal agency in Washington is under attack from congressional budget-cutters. But one seems to have been spared the ax: The IRS has been granted new allocations to add personnel to conduct taxpayer audits.

After staff cuts that began in 1998, when the agency was roundly criticized in Congress for aggressive collection tactics used on individual taxpayers, the IRS in the past several years has been given the green light to grow again. The 2012 budget calls for a 9% increase in funding to bring the total budget to \$13.3 billion. Administrators aim to spend \$339 million of that this year on new enforcement initiatives, with the goal of raising \$1.3 billion from errant taxpayers.

If it reaches that objective, the IRS will garner a glowing return on investment of 4.5 to 1. The agency has been cracking down since hidden Swiss bank accounts held by American multimillionaires first came to light three years ago. In 2006, 5.25% of all tax returns on incomes of \$1 million or more were audited by the IRS. By 2010, that percentage had risen to 8.36%. For small businesses with assets of less than \$10 million, just 0.32% of returns underwent close audits in 2004. By 2010, that percentage had nearly tripled to 0.94%.

Robert McKenzie, a partner at law firm Arnstein & Lehr LLP in Chicago who represents clients before the IRS, notes that the agency overall in 2007 conducted about 1 million computer audits. By 2010, that total had risen to almost 1.5 million. In 2009, he brought 110 clients with offshore accounts before the IRS as part of a voluntary disclosure program. This year he brought 30. Overseas banks ranging from UBS to Credit Suisse and HSBC have been under criminal investigation for their alleged roles in aiding tax evasion.

"The increase in audits, particularly of overseas accounts, has been a major irritant for some of my clients," Mr. McKenzie says. "Frankly, some of these people deserve to be audited. We often have to agree to significant deficiencies in taxes paid. Very often it's the operators of small and mid-sized businesses who have not fully complied with the law, sometimes out of ignorance."

The IRS declines to comment, but David Stafseth, a certified public accountant who works with Vogel Consulting LLC in Chicago, notes the Government Accountability Office estimates that about 84% of all U.S. taxes are paid voluntarily. "The shortfall is called the tax gap," he says. "The IRS in the past four years has been dedicated to reducing that gap."

Mr. Stafseth asserts that the rising prospects of audits haven't affected how most accountants prepare tax forms. But he says that some clients have turned conservative in claiming deductions. "I'm seeing clients who will tell me that if the deduction isn't absolutely black and white, they don't want to claim it," he says. "They don't want to deal with an audit if they can avoid it."

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