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TAX LETTER

INCOME, MORTGAGE INTEREST AND LIVING STANDARD

Recently, I have a chance representing a client for an IRS encounter. She was notified by the IRS to appear for a special “compliance interview” which her representative (myself) can not represent her alone. She must show-up, otherwise, the IRS will issue a summon for her appearance. She was selected by certain mystical model which attempt to match income reported in her tax return to some kind of statistical income figure which is, according to the IRS, necessary to maintain her standard of living in her “Zip Code” or in the Metropolitan area where she live. To satisfactorily complete this particular “compliance interview”, she must be able to demonstrate that she had reported all her taxable income. The income needed to maintain her living in excess of what she reported came from non taxable sources, i.e. gifts from her parents and/or child support from her ex-spouse, etc.

The metropolitan area or the “Zip Code” statistical living standard is not the only method that the IRS used to make their selection of taxpayer(s) for this special type of compliance interview or audit.

Form 1098 matching program introduced and recommended by the Treasury Inspector General for Tax Administration (TIGTA) is the second method adopted by the IRS. Under this method, the IRS will utilize the mortgage interest information provided by Form 1098 to set up certain sets of thresholds and criterions to select tax returns for further review and/or audit. The TIGTA made their recommendation based on the results of two of their sampling analyses.

According to them, one sample gave TIGTA about 219,600 potential non filers. From this 219,600 possible individual non filers, TIGTA randomly selected 100 for further review. They discovered that nearly 21 out of 100 (approx. 21%) reviewed were actual non filers, together they may owe delinquent income taxes as much as $177,700 plus approximately $107,000 in penalties and interest.

The other sample helped TIGTA to identify about 245,500 individuals whose reported 2005 AGI (Adjusted Gross Income) were less than the amount of their mortgage interest deducted on their income tax returns or reported on Form 1098 by the Lending Institutions. Again TIGTA, based on this discovery, randomly selected 100 tax returns from 245,500 for further review. As a result of their review, TIGTA found at least 37 out of 100 (approx. 37%) selected returns consist of certain understatement of income subject to tax. Based on this finding, TIGTA estimated that these 37 individual returns may have a combined $265,000 income tax deficiency. Likewise, interest and penalties for the deficiency could be about $61,200.

In conclusion, commencing now, the IRS will apply both the “statistical living standard” method and the “Form 1098 mortgage interest” method to select more tax returns for audit and/or for “compliance interview”.

Should you have any comment or questions, please feel free to give us a call at 415-381-0681 or visit our web site – chochan.com.

Sincerely,

Cho F Chan CPA, Inc.