DOWNEY & COMPANY, LLP

10 Ways Your Business Can Reduce the Risk of an IRS Audit

Small business tax returns are about three times more likely to be audited by the IRS than individual tax returns. These are the most common "red flags" that draw the attention of the IRS to small businesses and/or self-employed tax returns.

1. **Home Office Deductions** – Since the IRS began allowing home office deductions, they have been abused by individuals, either overstating or misusing them. This is why the IRS investigates these deductions more than any other. Be sure to have the proper documentation to support this deduction or skip the deduction altogether. If your home office deduction is large, or if you claim a lot of home maintenance or utilities, this is a red flag. If you claim both a home office and the expenses for an office you rent or own, this is an even bigger red flag.
2. **1099s** – If your business uses more subcontractors than employees, or if you issue a lot of 1099s at the end of the year, you are vulnerable to an audit. The IRS looks carefully at businesses that use more subcontractors than employees to determine if you are trying to avoid paying payroll taxes.
3. **A, C or LLC?** – If you file a large amount of expenses under "other" on Schedule A under "miscellaneous," this is a red flag to the IRS. Instead, itemize those business expenses under the correct categories on Schedule C. If you do file a Schedule C, be sure to have all the documentation to back up your deductions. Statistically, if you file a Schedule C, you are more likely to get audited than businesses that do not. Better yet, consider forming a separate business entity (LLC, S Corp, Corporation) and put expenses through the entity instead of a Schedule C.
4. **Entertainment Deductions –** Historically this deduction has been abused quite a bit by individuals trying to charge too many entertainment or business meal expenses to the business. This will raise a red flag if the amount charged seems too large compared to the size of your business.
5. **Hobby or Business?** – Businesses have to show a profit three of every five years. If they do not, the IRS may classify the business as a hobby. The IRS does not allow you to deduct hobby expenses on your tax return. The IRS will require you to prove that your business is legitimate and not a hobby, if you are audited for this reason.
6. **Low Income and Large Deductions –** When small businesses report low income and large deductions, they tend to be claiming more than what is actually allowed. While this is legitimate, especially for newly formed companies or companies having a rough year, this will raise a red flag to the IRS.
7. **Claiming a Loss** – Claiming a loss on a business is an immediate red flag to the IRS because no taxes will be paid on the business. The IRS may speculate that you may be taking deductions that are not allowed in order to not pay taxes.
8. **Executive Compensation** – The IRS is carefully examining executive compensation. If large salaries are paid to officers of C Corps, the IRS will look at that corporation's tax return, as large salaries will reduce corporate income and, in turn, corporate tax liability.
9. **Quarterly Taxes** – If you think you will owe taxes at the end of the year, pay quarterly taxes. If you pay your quarterly taxes promptly, this could decrease your chances of getting audited.
10. **No Estimating** – Do not estimate expenses or income on your tax return. Don't estimate that your real estate taxes were $5,000 and utility expenses were $2,000. Using round numbers for expense line items can draw additional scrutiny from the authorities.

Finally, some of these suggestions may sound extremely basic, but they are worth mentioning to help you organize what you will need to file your tax return and reduce the risk of getting audited. Keep a separate business bank account, business credit card, and business record keeping system from your personal ones. When filing your tax return, do not make math errors or file a messy or handwritten tax return which will draw the immediate attention of the IRS to your return.

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