

## What IRS Auditors Look for When Examining a Business

In the case of audit, be aware that the IRS training manual tells its auditors that they are examining you, not just your tax return. The auditor wants to see how you match up with the income reported on your return, or what the IRS terms “economic reality.” According to Frederick W. Daily, tax attorney and author of *Stand Up To the IRS* and *Tax Savvy for Small Business*, if your business is audited, the IRS is likely to investigate the following issues:

- *Does your lifestyle square with your reported income?* “An auditor sizes you up for dress, jewelry, car and furnishings in your home or office, if given a chance to make these observations. Someone who looks like a Vegas high roller, with the tax return of a missionary, will cause any auditor to dig deeper,” Daily says.
- *Does your business handle a lot of cash?* If your business handles a lot of cash, expect the auditor to suspect skimming, or diverting income into your own pocket, without declaring it.
- *Did you write off auto expenses for your only car?* Personal use of your business-deducted set of wheels is so common that auditors expect to find it. That doesn’t mean they’ll accept it, however. Auditors don’t believe you use your one-and-only auto 100% for business and never to run to the grocery store or the dentist. If you operate your car for both business and pleasure and claim a high percentage of business usage, keep good records (preferably a mileage log).
- *Did you claim personal entertainment, meals or vacation costs as business expenses?* Travel and entertainment business expenses are another area where the IRS knows it can strike gold. Document all travel and entertainment deductions. Taking buddies to the ball game and calling it business won’t fly if you can’t explain the business relationship in a credible fashion.
- *Did you “forget” to report all of your business sales or receipts?* If you failed to report significant business income—\$10,000 or more—strongly consider hiring a tax pro to handle the audit. Remove yourself from the process altogether.
- If the auditor finds evidence of large amounts of unreported income, and it looks intentional, he may call in the IRS criminal investigation team.
- *If you have employees, are you filing payroll tax returns and making tax payments?* Employment taxes are a routine part of every audit of a small enterprise.
- *And last but not least, if you hire people you call “independent contractors,” are they really employees?* The IRS routinely conducts audits of businesses that hire independent contractors, because of the tax savings associated with hiring contractors instead of employees.

This list is by no means complete. These are just the most likely things an IRS auditor will look for, Daily notes. If your small business is being audited by the IRS, speak with your accountant, tax preparer or tax attorney about the steps you need to take to prepare.