

How to Prepare for a Tax Audit

A tax audit is an experience every businessperson hopes to avoid. If the IRS does pay your business a visit, understanding what an auditor might look for can make the difference between a minor inconvenience and a major hardship.

During a full-fledged audit, an IRS agent may look at several specific items in your tax return and business records, including:

Income. The IRS will compare your bank statements and deposits to the income you reported. They will also review your invoices, sales records and receipts, along with your general ledger and other formal bookkeeping records.

If you received gifts of money or an inheritance, keep records to document how much you received. Without proof, the IRS may classify these as income and tax them as such. They will also classify any exchange of goods or services in lieu of cash (such as barter transactions) as taxable income.

Expenses and deductions. An auditor may compare canceled checks, bills marked “paid,” bank statements, credit card statements, receipts for payment or charitable gifts, and other business records to the expenses and deductions you reported on your return.

They may pay special attention to reported debts or business losses; charitable gifts; and travel, meal and entertainment expenses. Keep a log to substantiate travel, meal and entertainment expenses, and be sure to deduct only legitimate business expenses.

Loans and interest. An auditor may review loan paperwork, deposits, bank statements, credit card statements, receipts and canceled checks to verify that you used borrowed money only to cover business expenses. This is important, since you may deduct interest on business-related loans.

Employee classifications. The IRS will review employee classifications on your return and check this data against time cards, job descriptions, benefit plans, invoices, canceled checks, contracts and other business records. Auditors will pay particular attention to independent contractor classifications, since many firms improperly classify regular employees as contractors.

Payroll. Auditors will examine canceled checks, tax returns, deposits, business records and other forms to check for completeness, accuracy and timely filing. They will also review records documenting state, federal and Social Security (FICA) withholding, Medicare taxes, advance earned-income credit, unemployment compensation and workers’ compensation premiums.

The IRS will also examine salaries and bonuses paid to owners and officers of your business to be sure they are legitimate and within industry standards.

Other records. An auditor can also inspect records from your tax preparer or accountant, bank or other financial institution, suppliers, and customers. In addition to inspecting your business, an auditor may inspect your personal finances.

The IRS may compare your current lifestyle with the income presented on your tax return to determine if they are compatible. An auditor may also talk with others who are knowledgeable about you and your financial situation.

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