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Five Ways a Small Business Owner Can Prepare at Tax Time to Avoid a Future Income Tax Audit

IRS tax audits can be extremely disruptive to the operations of small businesses. There is never a good time to be involved in an audit. However, by taking key steps right now, as small business owners prepare for yearly tax filings, the business owner well-positions itself to reduce the likelihood of an audit or allows for the ability to successfully resolve an audit that the IRS may undertake.

1. Keep receipts. A major area for IRS audits of small businesses is deductions of business expenses. As a general rule, the taxpayer has the burden to prove his or her entitlement to deductions. This is best done by keeping organized copies of receipts that demonstrate business expenses. The best proof for the taxpayer is to have the actual receipt. The second best is credit card and bank statements. Worst case but still acceptable is estimating certain deductions if there is a lack of records. For many expenses, the IRS will permit estimated expenses under the understanding that a business will not make money without incurring expenses.

However, the small business owner must be especially aware that the taxpayer has a higher burden to prove expenses from travel and meals. For example, for the deduction of mileage, the taxpayer should keep a contemporaneous travel log showing the business purpose of travel, mileage, time traveled and destination. While the IRS may accept recreated records of travel expenses under some circumstances, that is the hard way to show the expenses. The IRS will typically not accept estimated travel expense records. Create a system today to keep receipts and contemporaneous records of business expenses.

2. Pay payroll taxes. Small businesses with employees have the obligation to collect and pay over to the IRS payroll taxes, which are withheld from employee checks for the employee's income tax and their share of social security, Medicare and Medicaid. Many small business owners file IRS Form 941 and remit these payroll taxes to the IRS on a quarterly basis. These taxes are often referred to as trust fund taxes because the employer holds the funds in trust to pay over to the IRS. However, if the small business gets behind on its

finances, it can be tempting for the business to use the trust fund taxes to pay other business expenses. The IRS zealously audits and collects these trust fund taxes. Management and others responsible for remitting payroll taxes to the IRS can be held personally liable under the IRS Trust Fund Recovery Penalty for the payment of the trust fund taxes. The IRS also may investigate the employer for criminal tax lability for failing to pay trust fund taxes. Create a system today to promptly separate and remit trust fund taxes to the IRS. If the small business is behind on these taxes, contact your tax professional right away to implement a plan to come into compliance and to avoid personal liability and potential criminal liability.

3. Document and separate personal vs. business expenses. Small businesses may fall into the bad habit of using a common credit card or bank account to pay both personal expenses of the business owner and the business expenses of the business. Take the time right now to stop this practice and open a dedicated bank account and credit card for the business. Mixing personal and business expenses brings numerous problems. From a tax side, the IRS may contest legitimate business deductions by throwing out all comingled deductions. From a non-tax side, by commingling personal and business expenses, the corporate taxpayer leaves itself vulnerable to piercing the corporate veil. Using the corporate form should protect the individual owner from personal liability from corporate debts. But if a court determines that the owner and the business entity comingle assets and do not observe corporate formalities, the court may determine that the corporation is the agent or alter ego of the individual and impose personal liability on the individual owner. Create a system today to separate business and personal income and expenses and observe corporate formalities.

4. Avoid "hobby loss" determinations. For individual taxpayers with full time employment or businesses and have a side business that seems "too fun" or generates too many losses, which losses often shield other income, the IRS may audit for and seek to deny those expenses as "hobby losses." There is a safe harbor that provides if a business generates a profit in three out of five years, that it will avoid hobby loss treatment. Otherwise, the IRS looks at various factors to determine if the business is bona fide making all the expenses deductible, or if it is a hobby and all expenses are not deductible. Side businesses that often catch the eye of the IRS as a "hobby" are anything to do with horses (racing horses in particular) and farms where high expenses are taken for depreciation of assets with little income produced by a farm or ranch and where the ranch is used for recreation. Create a system today by contacting a tax professional to document the information needed to demonstrate to the IRS that the business is a bona fide for-profit business and non a non-deductible hobby.

5. Material participation. Taxpayers with side businesses seek to deduct losses against income from other businesses. However, if the taxpayer is not "materially participating" in the business, the taxpayer may be generating only "passive losses", which can only be deducted against "passive gains." In order to materially participate and thus have active losses, which can offset other active gain, the taxpayer must meet one of the IRS tests for material participation. These tests can include participating for more than 500 hours, if participation of the taxpayer was substantially all of the participation in the business, participating for 100 hours and at least as much as other individuals, and others. Create a system today by contacting a tax professional to discuss whether you materially participate and be prepared to document the participation in the event of future audit.

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