Ten Frequently Audited Items

We've compiled a list of common situations where the IRS may choose to audit taxpayers.

1. Employee vs. Independent Contractor

The IRS started an initiative with the Department of Labor last year to identify workers that are misclassified as independent contractors. Making a determination on whether a worker is an employee or contractor involves many factors. The main areas looked at are behavioral control, financial control and relationship of the parties. When it is not possible to determine worker classification with this information, a written contract between the parties may be the deciding factor. It is important that businesses are able to support the worker classification they have in place.

2. Home Office Deductions

Business owners are allowed to deduct a portion of their home expenses if they qualify. The home office area must be used regularly and exclusively. Regular use means that you must use the home office to do work or meet with clients on a continuing basis. You cannot use the office only occasionally. Exclusive use means that the office is used for business purposes only. A guest bedroom where guests sleep or part of your dining room where you eat meals will not qualify. There are exceptions to these rules for daycare providers and for inventory storage purposes.

3. Real Estate Losses

A taxpayer who spends over 50% of their time and at least 750 hours or more each year participating in real estate may qualify as a real estate professional and be able to deduct losses that could otherwise be limited due to their income level. The IRS is scrutinizing these losses, and real estate professionals must keep detailed logs every day showing exactly what activity they were performing and how much time they spent on the activity. This is a very complicated area and should be discussed in detail with us.

4. Vehicle/Mileage Expenses

Business owners can choose to deduct either a standard mileage allowance or actual vehicle expenses. Ask your accountant to help you choose the best option when you purchase a different vehicle or start a new vehicle lease. If you are deducting the standard mileage allowance, you must have a detailed log with the amount of business miles you drove. If you are deducting actual vehicle expenses, you must have the same log showing your business miles, but also have a record of the total miles you drove that year. For actual expenses, you can deduct depreciation of the vehicle cost (may be limited), gas, oil, lease payments if leasing, insurance, registration fees, repairs, and tires. All of these expenses must be allocated based on the business percentage use of the vehicle.

5. Use Tax

Use tax is due for businesses that purchase an item without paying your home state's sales tax and use that item in your state. Some common examples are purchases of used office furniture on Craigslist, purchases of items by mail subscription, and purchases over the internet. When these items are purchased without paying sales tax, you must pay the applicable sales tax to your home state.

6. S Corporations Shareholder Salary

The IRS requires that S corporation shareholders be paid a "reasonable salary". The IRS is attacking S corporation shareholders who have low wages and are not paying enough payroll tax. An audit in this area can be very costly as the IRS decides what a shareholder's reasonable wage is and then assesses payroll taxes, penalties and interest on that amount. There are many factors that come into play when deciding what figure is a reasonable wage for a shareholder. Shareholders should have documentation to defend how their wage was determined and why it is considered reasonable. IRS assessments are especially hard to defend when a shareholder is not paying themselves any salary.

7. Meals, Entertainment and Travel Expenses

Detailed records must be kept to substantiate business meal deductions. You must keep all receipts, even if you pay for the meal on your credit card and have the credit card statement. You need to document who was present, what you discussed, and the business purpose of this expenditure. The IRS looks at whether or not you could expect to receive income or a specific business benefit in the future from this expenditure.

8. Charitable Contributions

No deduction is allowed unless the taxpayer has a cancelled check or written acknowledgement from the charity. If you give small donations to several different charities, writing a check will provide the proof the IRS requires. Any charitable contribution of $250 or more in any one day to one charitable organization requires the taxpayer to have a receipt from the charity in order to take the deduction. In this case, a cancelled check will not be sufficient. For charitable payroll deductions, a W-2 form or pay stub is all the documentation you need. Avoid cash donations as there is no way to prove your donation and the IRS will disallow the deduction.

9. Farm, Business and Hobby Losses

The IRS can challenge losses deducted for a business that doesn't generate a profit in three out of every five years. Businesses showing losses need to ensure the business can't be looked at as a hobby, but a serious business. A business plan that shows a possible profit, good records, and time and effort spent in the business help establish the business is not a hobby.

10. Multi-State Sales Issues

Do you have a business located in Pennsylvania that performs work in New Jersey? Are you paying sales tax, wages, and income tax to New Jersey? The states are looking more closely at businesses that have licenses in more than one state but are not filing income tax returns in the other state.