Good recordkeeping can help your business survive an IRS tax audit

According to the Tax Receipts website, small business owners are up to 940 percent more likely to be audited than W-2 wage earners. In particular, business owners who operate as sole proprietors or single-member LLCs face a much higher risk of being audited than the typical wage-earner. It is said that the IRS targets these taxpayers for increased scrutiny to root out tax fraud and reduce the federal deficit. The Wall Street Journal reports that the IRS tends to believe that many small businesses have a tendency to underreport income.

The Bankrate website observes that the IRS audits only a small percentage of tax returns. This is, of course, cold comfort if your business is one of those selected for a visit by a tax auditor. Businesses which are given notice of an audit have not been selected simply due to bad luck. There are usually reasons why the IRS decides to audit a business. One reason may be a tax return's Discriminate Function System (DIF) score.

The DIF computer program analyzes tax returns to determine if they lie outside statistical norms. The higher the DIF score, the more probable it becomes that the return will be selected for review. Bankrate notes that, even though the IRS does not reveal its DIF mathematical formula, deductions that are greater than reported income can increase a tax return's DIF score.

In addition to a high DIF score, an audit of your business could be triggered by the audit of a related party. By way of example, if the IRS audits the tax return of "Acme Widgets," and it appears that payments were made by Acme to your business, the IRS may check your business's tax return to make sure the payment was reported. If not, a tax auditor may soon be knocking on your door.

Recordkeeping

You need to maintain accurate records in order to monitor the progress of your business. Moreover, you also need to maintain accurate records in order to prepare and justify your tax returns. These records must support the income, expenses and credits that you report. While good recordkeeping may not, by itself, stave off an IRS audit, it can make dealing with an audit easier.

The IRS notes that the taxpayer may decide upon any recordkeeping system in tune with your business that clearly shows your income and expenses. However, it is imperative that your recordkeeping system include a summary of your business transactions. This summary is ordinarily made in business books such as accounting journals and ledgers. Your books need to show your gross income as well as your deductions and credits.

For many small businesses, the business checkbook is the primary source for entries in the business books. Many businesses choose to use electronic accounting software programs to capture and organize their business records.

According to Entrepreneur magazine, good recordkeeping entails keeping receipts that prove you are entitled to the business deductions claimed for items such as travel, dining and entertainment expenses. The failure to do so can put your tax return in peril. Receipts should be viewed as a form of "audit protection" and kept at least six years. One tip is to scan your receipts or use your smartphone to photograph the receipts.

Seek legal help

If you are a small business owner, you should consult with a Georgia tax attorney experienced in IRS audits, tax preparation and tax planning matters. An attorney can assist you in keeping your business compliant with applicable IRS rules and regulations.