

## How Your Home Business Can Avoid a Tax Audit

Some deductions are red flags to the IRS, and sometimes it's better to lose the tax deduction than to lose your mind worrying about an audit

by [Karen E. Klein](#)

**Q: I operate a small business out of my house. The thought of a potential IRS audit makes me lose sleep at night. Is there anything I can do to eliminate or reduce my chances of being audited? —J.C., San Leandro, Calif.**

**A:** There's no reason for an honest business owner to lose sleep worrying about a tax audit. Even if you are selected for audit, "There may be differences of opinion with the auditor, but in the end it's just additional taxes and some interest that may be owed," says Alan Weiner, a CPA and partner at [Holtz Rubenstein Reminick](#) in Melville, N.Y. And as long as you have the documentation to support your deductions, you should be fine, adds [Ronald Morgan, a CPA at Stern, Kory, Sreden & Morgan in Stevenson Ranch, Calif.](#)

Keeping your business income and deductions well within the averages for your type of business will reduce your chance of being audited, Morgan says, as will making sure that you're not taking unwarranted deductions. Other simple steps are making sure that you do not fill out your tax return by hand—use a software program or professional tax preparer—and that you attach all the paperwork necessary to back up any unusual deductions you do take. "Don't give the IRS a reason to contact you. If you are claiming a casualty loss for theft of business property, attach a police report," advises Barbara Rosenbaum, CPA with [Gumbiner Savett](#) in Santa Monica, Calif.

Some accountants advise clients to avoid filing the most often audited tax forms, such as the Schedule C for sole proprietors and the Form 8829, where you report the expenses for the business use of your home. These forms tend to catch the attention of the IRS, says Michael Hanley, a CPA and managing partner at Merl & Hanley in Smithtown, N.Y. The Schedule C, where sole proprietors report their business income and expenses, "is in the highest audit risk category...of approximately 3%," Hanley says. "A simple remedy to this problem is to incorporate. By incorporating, you reduce your risk of an audit to approximately .3%, making you about ten times less likely to be audited in a given year."

### WHEN AND HOW TO DEDUCT THE HOME OFFICE

The home office deduction acts as something of a red flag to the Internal Revenue Service because it can easily be abused by small business owners who claim a larger home office than they actually have, or who deduct expenses for an office that is not truly dedicated to business use. However, many accountants feel a home office deduction is so valuable that it should not be ignored. "Home office expenses are a legitimate deduction and should not be overlooked merely due to audit fear. There are many things in the world that tend to result in anxiety. A home office, in my opinion, is not one of them," says Donald Lucove, a CPA with Lucove, Say & Co in Calabasas, Calif.

Weiner stakes out some middle ground on the home office deduction question: "You could simply forgo the

deduction, since a home office always is something that the IRS looks at," he says. "As a tax professional, I don't like to see taxpayers give up deductions to which they are entitled, but tax advisers are also part-time psychologists—without the formal training—because their clients confide in them. It may be cheaper for you to forgo some tax deductions, get more sleep, avoid medications from loss of sleep, and avoid seeing a professional psychologist."

If you do take the home office deduction, remember that the space must be used regularly and exclusively for your business. Take pictures of it and keep them with your tax records, just in case.

Some additional tips:

- Hire a reputable tax preparer to prepare your return, rather than a nonprofessional who took a course in tax preparation. CPAs are licensed and are required to take continuing education courses. Large tax preparation services, such as H&R Block ([HRB](#)), have qualified personnel supporting their preparers. Preparers whose tax returns are audited frequently will be flagged as disreputable, opening up their entire client base to be audited, Hanley says.
- Make sure your reported income supports your living expenses and other deductions.
- Do not round off your deductions, which might make it appear that you are "guesstimating." Exact figures appear to be taken from actual records.
- If you're worried about the impact of the Schedule C, you could investigate forming a corporation to reduce your possibility of audit. "That may sound attractive, but the cost of formation, together with the cost of annual tax return filings and possible payroll tax responsibilities, may outweigh the perceived benefits," Weiner says. Talk to an accountant about the [pros and cons of incorporating your company](#) (BusinessWeek, 10/3/07).
- Report all your income. "If the IRS matching program, which compares 1099s, W-2s, and other forms filed with the IRS to tax returns, reveals unreported income, you get a notice. Don't invite unwanted attention," Rosenbaum says.

*[Karen E. Klein](#) is a business journalist who covers small-business issues for several national publications. She writes her Smart Answers [column](#) twice a week.*

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