

What If The IRS Knocks On My Door? How To Handle An Audit Of Your Business.

7 min read



Key Takeaways

- **Top 6 IRS Audit Triggers in 2021 for Businesses:** While the odds of getting audited this year are still relatively low, you are still at risk, and the following tax-audit triggers could increase your chances of getting audited.
- **What to Expect: How to Handle an IRS Audit:** If the IRS selects your business for a tax audit, you will be notified by mail, in writing usually with a Notice 566S.
- **Surviving an IRS Audit: How and Why You Should be Tax-Ready 365 Days a Year:** We'll cut to the chase: the key to staying tax and audit-ready 24/7 relies on your back office procedures.

The pandemic brought on many tax changes- including the uptick in small business audits. In 2020, the **IRS announced its plan to increase small business tax audits by 50%** in 2021^[1].

This is likely the *last* thing business owners need to worry about. Plus- the dreaded IRS tax audit is often accompanied by fears of missing receipts, disorganized records, non-compliant bookkeeping procedures, and inaccurate tabulations.

While the fear of a tax audit cannot be denied, we're here to tell you that when the IRS knocks at your door, it doesn't have to be quite so dreadful.

With the right preparations and back-office systems, policies, and procedures in place, you can be ready to welcome an IRS auditor with, perhaps, a little excitement to show them just how ready you are for their "scary" tax audit.

What Are the Chances of Being Audited by the IRS in 2021?

In 2015, the most recent year for which the IRS has published data, a total of 850,000 tax returns were audited, or about 1% of all returns. With the exception of low-income taxpayers who claimed the earned income tax credit, generally, filers with more than \$500,000 in reported income are more likely to be audited^[2].

Although you might not believe it based on the amount we all pay in taxes, the reason the percentage of audits is so low is simply that the IRS is underfunded and short on staff.

Over the next decade, however, the odds of getting audited are likely to increase, as President Biden plans to give the IRS \$80 billion for the purpose of auditing more corporations and high-income taxpayers^[3].

So, while the odds of getting audited this year are still relatively low, you are still at risk, and the following tax-audit triggers could increase your chances of getting audited.

Top 6 IRS Audit Triggers in 2021 for Businesses

First things first- let's get into the red flags for trigger IRS audit. We'll cover how to be audit-ready 24/7 later...

1. Errors, Typos, and Inaccuracies

Math errors, typing mistakes, and missing documents like 1099s are big triggers for business audits. Double-check your math on your filing (even if your accountant prepares your returns) and make sure you include all the documentation required.


Read More: [5 Advantages of Automating Manual Processes In Your Business](#)

2. Excessive Deductions

While there's nothing wrong with claiming deductions on business-related expenses on your tax filing, claiming excessive deductions in relation to your revenue can trigger an audit. The IRS has thresholds for determining how much of a deduction is too much at different levels of income.

So, if you deduct expenses like business vehicles, a home office and business-related travel, meals, and entertainment, be sure the deductible amounts you report follow IRS regulations. Additionally, you must have accurate documentation of their use and receipts for all the expenses.

"The IRS is at my door! What do I do?"

👉 In his 3 decades of supporting businesses with their financials, GrowthForce CEO Stephen King has seen it all. Listen to real fraud cases Stephen has encountered and tips on how to reduce your risk (so you don't wind up in a similar situation).  [Listen to the full episode here](#)

3. Low or No Salaries Paid in an S-Corp

Many small business owners decide to register as S-corps, instead of independent contractors to avoid paying self-employment tax. There's no problem with doing this, but

you must pay yourself a reasonable salary, reported with a W-2, to avoid getting audited and operating non-compliantly.

4. Continuous Losses on a Schedule C

While it's normal for startups to experience initial losses and for established businesses to have the occasional difficult year, it's not normal for a business (the purpose of which is making money) to incur losses year after year after year.

As a result, recurring losses tend to trigger audits – especially, if you are registered as a sole proprietorship. The IRS wants to ensure you're not treating a hobby as a business for the purpose of writing off craft supply expenses.

5. Cash Transactions

If you operate a cash-based business, then you're more likely to get audited because cash transactions are more difficult for the IRS to track. Like deductions vs. income, there are thresholds for the percentage of total cash transactions that occur in businesses in various industries that will trigger a tax audit.

To avoid unwanted IRS attention, it's important that all cash transactions - accounts payable and accounts receivable - be properly recorded, with supporting documentation attached.

6. Number of Independent Contractors Compared to Employees

It's completely acceptable for your business to hire independent contractors. However, hiring a large number of contractors compared to the number of actual employees in your business can trigger an audit.

Some businesses misclassify their employees as contractors in order to avoid paying proper payroll taxes, worker's compensation, and disability.

It's fine to hire contractors. Just be sure you're following the IRS's worker classification guidelines and not misclassifying any employees as contractors [4].

What to Expect: How to Handle an IRS Audit

If the IRS selects your business for a tax audit, you will be notified by mail, in writing usually with a Notice 566S. You'll receive a list of documents that you will need to provide. Keep receipts and other records for up to 7 years and property records for as long as you own the property.

You can obtain counsel from an enrolled agent, CPA, or lawyer to act on your business's behalf during the audit. This can help the process go more smoothly, as they understand what you'll need, can help you legally recreate documents if necessary, and also have a complete understanding of your rights during the audit process.

Read More: [Your Business Audit Will Cost You, Unless...](#)

Your audit interview where your records are reviewed will either be conducted over the phone, in person, or by mail.

Surviving an IRS Audit: How and Why You Should be Tax-Ready 365 Days a Year

Like keeping a clean house in case you decide to welcome unexpected visitors into your home, you should be tax-ready every single day of the year because a tax audit could happen at any time — and you have no choice when it comes to welcoming the IRS into your business's financial records.

We'll cut to the chase: the key to staying tax and audit-ready 24/7 relies on your back office procedures.

When you're tax-ready 365 days a year, you never need to worry about an audit. Of course, you will probably go ahead and worry anyway, but always having an organized and accurate back-office and operating with properly established internal controls means you can face down a tax audit with confidence that you're adequately prepared.

While a lot goes into staying tax-ready throughout the year, you can take a couple of actions that will go a long way in improving your record-keeping and back-office compliance:

- Automating Processes
- Establishing Internal Controls

Automating processes not only saves time every time you need to record an expense and file a receipt, but it also improves the accuracy of your accounting, as it significantly reduces manual human error. Automation has the potential to keep you ready for an audit while also helping to lower the odds that inaccuracies in your tax return will trigger one.

Establishing internal controls improves your bookkeeping and accounting processes to ensure more accuracy and efficiency by implementing checks and balances. (This also reduces the chances for internal fraud in your business.) Additionally, internal controls ensure you're operating in compliance with rules and regulations, and this will help you come out of an audit unscathed.

Always Be Audit Ready With an Outsourced Accounting Partner

Teaming up your business with a highly experienced outsourced accounting service provider can help you design a perfectly automated back office for your business. You'll have access to the best tools and technology and the knowledge of experience to implement a sound system of internal controls and accurate, efficient procedures that ensure you'll be ready for a tax audit anytime the IRS comes knocking.

<https://www.irs.gov/about-irs/irs-audit-rates-significantly-increase-as-income-rises>

<https://www.forbes.com/advisor/personal-finance/biden-american-families-plan/>

<https://www.irs.gov/businesses/small-businesses-self-employed/independent-contractor-self-employed-or-employee>