

# Business Owners: Lower Your Red (Audit) Flags

*Lets Talk Tax*

By: Brett Hersh, EA, MBA

If you are the sole owner of an unincorporated business and have not elected to be treated as a corporation for tax purposes, you are considered a “sole proprietor.” Sole proprietors report their business income and expenses on *Schedule C, Profit or Loss from Business*. Schedule C then becomes part of your individual tax return, Form 1040. Sole Proprietorships are the most common form of business in the United States, making Schedule Cs the most common business form filed with the IRS.

**Top IRS Target:** Unfortunately, the IRS attributes much of the United States’ “Tax Gap” - the difference between taxes that should be paid and tax actually reported – to errors made by sole proprietors’ on their Schedule Cs. The underreporting of tax by sole proprietors has made business owners and their Schedule Cs, among the most targeted for IRS audit.

Today, I will discuss several “red-flag” errors that invite IRS scrutiny of sole proprietors and their Schedule Cs.

- **Incorrect Business Classification Code:** One of the most common mistakes made on Schedule C is entering the wrong business classification code. The business classification code is reported in Box B of the 2011 Schedule C. It tells the IRS what type of business/industry the proprietor is in and is used to compare the business’s reported income and expenses to those of similar businesses in the same industry. If items reported on a particular return have a high deviation from the averages reported by others, it is more likely to be selected for review.

Using an incorrect business code, or the entering the audit-inviting 99999 (for an unclassifiable business) can drastically increase the chances of “further review”. Lower this red flag by taking the time to select the classification code that is most appropriate for your business.

- **Auto Expenses:** More errors are made reporting vehicle business expenses than virtually any other Schedule C item. These errors are caused by three factors: 1) Most sole proprietors use their personal vehicles for business purposes, 2) The rules regarding the business use of personal vehicles are complex and often confusing, and, 3) Many owners do not retain the records necessary to substantiate the vehicle deduction claimed.

This article is not long enough to address the complexities of claiming the auto but it will allow me to share the following cautions:

1. Only legitimate business vehicle use is deductible (and there many rules defining business use).
2. Most owners can deduct auto expenses in one of two ways: actual expenses, based on the percentage of annual business use, or by using an allowable mileage allowance for each vehicle.  
**Be very, very careful** if you decide to switch between the two methods in different years.
3. Owners must have some form of a business mileage log to substantiate the business use claimed.

The IRS is well aware of these rules. Owners can lower this red-audit-flag by understanding and following these rules or by seeking professional assistance.

- **Claiming Business Losses Year After Year:** The reasoning behind this red flag actually makes sense. Being in business, by its very definition, means a profit motive exists. The IRS generally gives new businesses two years of losses (more for some industries) before the owner must be able to show a profit motive (also called “material participation”).

If the owner cannot show a profit motive, the IRS could reclassify the activity as a hobby, making revenues taxable, expenses only deductible as an itemized deduction, and no loss allowed. For more information, please see my article, *The Hobby Tax-Trap*, at the *Journal-news.net* or in the articles section of *hbsbusiness.com*.

This article has discussed three red-flag areas sole proprietors should be aware of when completing Schedule C. There remain, however, many rules, limits and requirements not included in this article. In my next column, we will discuss another error-prone deduction, the home office deduction. Until then and, as always, please remember that this or any article does not constitute or replace the advice of a qualified professional. If you have any questions regarding your taxes, please feel free to call our office at (304) 267-2594 to speak with a tax professional.

*Brett Hersh is the owner of HBS TAX and an Enrolled Agent with the IRS. Brett is licensed to prepare all tax returns and represent taxpayers before the IRS. He is also a trainer for Lorman Education and Dave Ramsey's endorsed provider for accounting and tax services for the region. He can be reached at (304) 267-2594 or through [www.hbsbusiness.com](http://www.hbsbusiness.com)*