

Audit Protection Kit

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Introduction

IRS Audits are up and there is no sign of reprieve in the near future! Congress has identified a \$300 Billion Dollar tax gap and has signaled to the IRS that they intend to close that gap. The IRS has received the message loud and clear and has stepped up audits. Modernization to IRS computer systems and more savvy IRS agents will increase chances of an audit for 2009 and beyond.

Following the guidelines in this audit protection kit does not guarantee you will not be audited. Rather, it will greatly lessen your chances if you follow these recommendations. The following pages will walk you through the major IRS audit areas and guide you on how to treat specific deductions. It further provides specific protection measures and strategies to take in order to avoid the audit.

Areas of major audit include:

- Office in the Home
- Meals & Entertainment
- Auto Expense – Actual vs. Standard Mileage
- Independent Contractor vs. Employee
- Business vs. Hobby
- Mortgage Interest vs. Equity Interest
- Charitable Contribution Rules
- Common IRS matching areas
- Small Business Hot Spots (Schedule C)
- S-Corporation Hot Spots (???)

Read through each category and answer the questions where appropriate. Take the resultant information to your tax professional or incorporate it into your tax return.

About the Authors

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Office in the Home

There is no business deduction which has created a larger stir than the deduction for using a part of one's home as an office. Both sides, the IRS and you the taxpayer, have strong feelings in regard to this deduction. No deduction of this small amount has been litigated so much in the courts and more vociferously and assertively audited than "office in the home".

Before getting to the official rules let's make this easy. Generally speaking, if you are employed by someone (or a corporation) and are provided a place to work you do not qualify for this deduction. This deduction is mainly for self-employed individuals who operate or perform the day to day management tasks from their home.

To qualify for office in the home you must meet the following tests:

1. Room or area used must be specific and exclusively used on a regular basis for your business. This means the kids should not be using this space to do their homework or surf the internet.
2. Room or area must be your principal place of doing business, or
3. It must be a place you regularly meet with patients, clients, or customers in the normal course of business, or
4. It must be a separate structure that is used in the trade or business and is not attached to your house or residence.

So you're a plumber and you mainly work at customer sites. Essentially, you have no "principal place of doing business" because you are always working at different locations. The IRS made things easy for you in this situation. They will generally allow the deduction;

1. As long as you use your "principal place of business" exclusively and regularly for 10 to 12 hours per week for administrative and/or management activities of your trade or business, and;
2. You have no other fixed location where you conduct substantial administrative or management activities of your trade or business. (IRS Publication 587)

If you have more than one principal place of business the IRS will look at the following additional factors:

1. The time you spend at each location (there should be more time spent at the location that is being deducted as "office in the home"). Or at least the time at the office in the home location is spent doing administrative and/or managerial tasks.
2. The portion of income earned at each location (the majority of income should come from the location being deducted as "office in the home").
3. Facilities available at each location (can one legitimately conduct business at the location being deducted as "office in the home").

For example: You are an independent insurance agent and are provided a cubical at the local agency office, but you run the administrative and management functions from your home office. All of your sales functions, like meeting with clients and making sales calls, are done from the insurance agency office. In this situation you have segregated your job functions to specific locations. And since your administrative and managerial functions are confined to your home office for at least 10-12 hours per week you are allowed to deduct the office in the home expenses.

So now we've determined that you can deduct the office in the home expenses, what exactly are these Deductible Expenses for "office in the home"?

The business portion of:

1. mortgage interest and property tax;
2. repairs & maintenance to the overall home that help the business, in addition to direct repairs for the office itself;
3. janitorial service or maid
4. utilities
5. insurance
6. depreciation (for real estate use a straight line of 39 years)

Office in Home Protection Measures:

So you qualify for office in the home. How do you protect yourself from the auditors?

1. Forego the deduction. Many times the tax savings from the deduction winds up being so little that it is almost not worth the audit risk. Consider not taking the deduction – it will make preparing your tax return that much easier, too.
2. Document client meetings at your home office – record in your day organizer.
3. Document the business activities performed in your home. As a plumber, most of your work hours are performed outside of your home office, but you may perform all of your management tasks at your home (bookkeeping, ordering supplies, setting up appointments, writing reports, etc.).
4. Use the proper office size measurements – IRS may question a 1,000 square foot room, but a 120 square foot room sound much more realistic.
5. Take a digital picture of the office for your tax files. If you have blue prints of your home, keep them to show the auditor the room used for business. (They have actually asked for this from taxpayers!)
6. In the rare case that you are employed and your employer **REQUIRES** you to work from your home (for the EMPLOYERS convenience) make sure you have a letter from your employer stating that you are **REQUIRED** to work from home. This is generally the case for regional sales managers where the corporate headquarters are in another state.

Relevant Strategies for Using Office in the Home

Once you have established your office in the home there are a few strategies you can employ to maximize this deduction.

First, since you have now established your principal place of business as your home address now every time you travel somewhere for business the expense is now deductible. Normally you are NOT allowed to deduct commute mileage to and from work. But if your work is in your home there is no commute. So now when you visit clients all the travel expenses are now deductible.