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[Feature]

Tax Manned

Are you armed and ready to be audited? The IRS has new and improved systems�and intends to use them to target small businesses.

By Karen D. Schwartz

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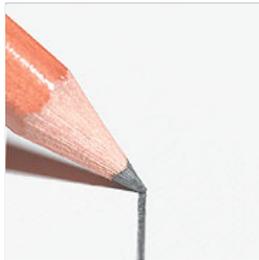
Business Perspective

Even though small businesses face fewer audits than in recent years�in fiscal 2004, 7,290 small companies were audited, down from 13,680 the previous year�the Internal Revenue Service has announced it will focus more attention on small businesses.

In an effort to boost enforcement revenue, IRS Commissioner Mark Everson recently said that his agency has created a division that will monitor the tax returns of self-employed individuals and small businesses with assets of less than $10 million. Enforcement revenue is money the IRS receives from auditing and collection efforts. "The IRS isn't necessarily auditing more, but it is auditing smarter," says Douglas Stives, a partner in The Curchin Group LLC, a financial and management services firm in Red Bank, N.J.

To fulfill its goals, the IRS has become more specialized, developing the Market Segment Specialization Program (MSSP) to train auditors on specific market segments, such as the construction or floral industries, and on particular tax issues, such as the rehabilitation tax credit. Armed with this information, an auditor will know what deductions and income are typical for vertical industries.

In turn, there are steps small businesses can take to prepare for a possible audit by the IRS. With the right approach, they can navigate the process relatively unscathed.

Preparing for the Audit

A good record-keeping system and an ability to support company tax returns will minimize the time and effort involved in the audit. Good records also decrease the chance that the IRS will identify problem areas, says Mary Wilson, a senior tax manager in the New York office of Rothstein Kass Certified Public Accountants, an international accounting and consulting firm.

During an audit, the IRS first looks for documentation to be in order�everything from invoices, receipts and canceled checks to profit-and-loss statements, payroll and car logs, and balance sheets. Making sure information is well organized before meeting with the auditor is almost as important as keeping good records in the first place, Wilson says.

"Don't show up at the appointment with a shoebox full of papers and start searching for the one document the IRS requested," she says. "If you do, the IRS may start looking at all those other pieces of paper and then delve into more areas than they had originally

intended." If a business owner needs more time to organize records, Wilson recommends asking the IRS for an extension instead of walking in unprepared.

In preparing for the audit, the IRS agent is likely to consult the MSSP for the small-business owner's specific market segment, as well as the agency's *Audit Technique Guides (ATG)*�industry-specific manuals that detail everything from the history of an industry to a glossary of its terminology and typical business practices. The guides also list dozens of questions auditors can ask owners of specific types of businesses. For example, the *ATG* for pizza restaurants suggests that auditors ask whether the business pays employees or buys ingredients in cash, the percentage of take-out versus eat-in business, whether any relatives work in the business, how cash register receipts are maintained, which menu items sell best, which ingredients are subject to spoilage, who supplies each ingredient and whether the business owner rents or owns machinery.

Speaking the Language

"The IRS speaks a certain language that you and I don't know, but CPAs know that language," says Jim Blasingame, host of *The Small Business Advocate*, a nationally syndicated radio and Internet talk show. "And the CPA will know what needs to be done immediately, what needs to be answered and what doesn't and what can be put off until tomorrow or next week."

A CPA on board offers other benefits. "Frequently, I don't take much with me when I meet with agents for the first time�just copies of tax returns and some of the information the client gave me," The Curchin Group's Stives says. "By going partially unprepared, I'm better able to find out what areas they're going to go into deeply and what areas they're going to let pass. Once I know that, I can create a better strategy."

In fact, Stives says he often meets with the IRS without his client because it takes the emotion out of the process and prevents clients who are uninitiated to the IRS from saying something that could damage the process.

Although hiring a CPA and becoming familiar with what the IRS agent might know about the industry in question are critical, good records are key to surviving a tax audit, experts say. In fact, preparing for an audit starts long before the IRS sends out that notice. Ideally, it starts the day a small business opens its doors, in the form of excellent record-keeping procedures and stellar organization of all business documents.

"When you invoice your client, have a system. When you pay your bills, have a system. If you drive a car for business, keep an impeccable diary. If you do business entertaining, make sure you have the receipts and the business purpose," Stives says. "Keeping good records goes a long way with the IRS."

CEO Takeaway
The IRS has created a special division to monitor small-business returns.
Auditors are trained in the specifics of various industries, meaning they may know almost as much as the owners about a business.
Take a tip from the Boy Scouts: Be prepared.
Keeping good financial records is the best defense.

Better Record-Keeping Through Technology

Keeping good records is the best way to survive an audit, and the best way to ensure good record-keeping is by using one of the many financial-management software packages on the market.

Although each has its own slant on record-keeping, these software packages make maintaining a running record of tax-deductible business expenses�everything from capital expenditures to gas mileage�a fairly simple matter. Most packages also allow businesses to create invoices, pay bills, track payments and create a number of automated reports. Most importantly, however, they provide full paper trails, which can help immensely in the event of an audit.

Many of these packages are geared toward small businesses and are fairly affordable, ranging from less than $100 to about $1,000. If a business owner is strapped for cash or isn't ready to dive into a full-fledged software package, any spreadsheet system is better than nothing, says Douglas Stives. "The most important thing is to keep good records, and if you're not going to use one of the popular software packages, at least get everything on spreadsheets," he says. "That way, if you're audited, you'll be able to find what you need quickly, and everything will be in order."

Audit Triggers

Failing to select an appropriate classification for the business on the tax return.

Not filling out every applicable line on the tax return.

Failing to pay employment taxes on time.

Submitting a return that looks homegrown; use a computer and a software program designed to calculate taxes and reproduce tax forms, such as TurboTax.

Not attaching appropriate detail schedules for forms where needed.

Using round numbers, which may indicate estimated expenses, income or deductions.

Having drastically different financial data (salary, expenses, etc.) than others in the profession.

Making large check or cash deposits in January of the new year.

Claiming business travel expenses, especially when two people travel together.

Recording large changes in the ratio of selling expenses to sales.

Claiming high meal and entertainment expenses with relatively low income.

Taking large deductions for business uses of automobiles.

Showing large amounts of inventory at the beginning of the year and no inventory at the end of the year.

Making mathematical errors.

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