

Surviving an IRS Audit — Tips for Small Businesses

Whether you run a consulting firm with \$5 million in annual revenue or a street corner hotdog stand that brings in \$20,000 a year, an Internal Revenue Service (IRS) audit of your tax returns has the potential to be one of the most stressful experiences you'll encounter as the owner or operator of a small business. But with proper planning and a clear understanding of what to expect, you can significantly improve your odds of emerging relatively unscathed..

What the IRS Looks For

IRS auditors are trained to ferret out the truth about your business's income and tax liabilities. They are likely to scrutinize business practices and search for filing errors to make sure that you have paid every penny you owe. Whether they request a face-to-face meeting or choose to conduct an audit through correspondence, the following areas are likely targets of IRS scrutiny.

Unreported income — The IRS will assess tax on any "missing" amounts, plus interest and penalty charges, regardless of whether the omission was accidental or intentional. A finding of significant fraud could even result in criminal prosecution and jail time. If you expect to be grilled about unreported income, consider hiring a tax professional to help you through the audit.

Personal vs. business expenses — Be prepared to prove that expenses you've claimed for business purposes were not actually personal expenses. Auditors pay particular attention to deductions related to entertainment, meals, travel and transportation. Keep all receipts and be ready to answer questions about the connection between each expense and your business. If you drive your car for both personal and business

reasons, maintain a detailed mileage log with a column for each type of use.

Employees vs. independent contractors — If your business employs independent contractors, the IRS will want to make sure that you're not avoiding paying payroll taxes on individuals it considers employees. If a worker has a business of his or her own and offers services to other businesses, the contractor designation is likely to hold up. If you tell an individual where, when and how to work, the IRS may consider that person an employee. Misclassifying a worker could result in taxes, interest and penalties.

The IRS also has a Market Segment Specialization Program (MSSP) designed to train its auditors on the intricacies of dozens of specific business niches, ranging from Alaskan commercial fishing to car washes to the scrap metal industry. The Audit Technique Guides are available online at www.irs.gov (look under the "Businesses" heading), so you can check to see whether your industry is included in the program. If it is, studying the relevant guide might help you get inside the head of your auditor, so to speak.

How to Prepare

Even if you expect your audit to go smoothly, it is still a good idea to enlist the services of an experienced tax professional to help you through the process. For example, a professional is probably more familiar with the complexities of ever-changing tax laws than you, and is also less likely to let emotions cloud his or her judgment. In addition, letting a professional speak on your behalf reduces the chance that you will accidentally volunteer information that could hurt your case.

There are simple steps you can take on your own, too. One obvious way to make a good first impression during an audit is to have all of your business records organized in a neat and logical manner. Doing so will help refresh your memory about important details, and it just may inspire an auditor to give you the benefit of the doubt in case you are unable to document a particular claim.

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Be sure you have the following records handy:

- Receipts and invoices for income and expenses
- Bank statements and cancelled checks
- Accounting books and ledgers
- Computer printouts of data you used in the preparation of your return
- Leases and/or titles for business property

Your Right to Appeal

After all is said and done, what happens if the auditor rules against you? The first step in the appeal process typically involves requesting a meeting with the auditor's supervisor in order to review your case and explain why you think the auditor's conclusions were unfair or incorrect. If that doesn't solve the problem, you have the right to schedule an appeals conference,

in which you may represent yourself or hire a lawyer, certified public accountant or other professional to state your case. If that meeting does not produce the results you'd hoped for, you have the right to take your appeal to court.

Keep in mind that interest and penalties imposed during the audit will continue to compound during the appeal. Also, an appeals officer may raise issues that hadn't come up before, so you run the risk of opening a whole new can of worms with each additional interaction you have with the IRS.

Before deciding whether to appeal the results of an audit, read IRS Publication 5 (Appeal Rights and Preparation of Protest for Unagreed Cases), Publication 556 (Examination of Returns, Appeal Rights and Claims for Refund), and Publication 1660 (Collection Appeal Rights). The publications are free and available online at www.irs.gov or by calling 1-800-829-3676.

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