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Small Business Alert

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Three Key Small Business Tips for Surviving an IRS Audit

According to the team at Legal River in Bethesda, MD, IRS auditors will “...likely scrutinize your business practices and check for any errors you may have made in the filing process to make sure you’ve paid every dime you owe.”

The following areas are those most typically put under the microscope by the IRS.

Unreported Income

The IRS will seek out and probably find any amounts that were left off your tax filing and assess tax, interest, and penalty charges on any missing amounts. “Should the IRS auditors find proof of significant fraud, you may find yourself facing criminal prosecution and jail time,” Legal River said.

Personal vs. Business Expenses

You better be ready to prove that all costs you’ve claimed as business expenses were truly business-related and not of a personal nature. “Auditors will pay particular attention on deductions categorized as entertainment, meals, travel, and transportation,” the Legal River team said. “Retain all your receipts and be ready to provide specific answers to questions about how each expense relates to your business.”

You may want to make notes on the backs of receipts when you incur expenses so you aren’t trying to jog your memory months later. “Maintaining detailed expense logs may also be a good idea,” they added.

Employee or Independent Contractor?

“If you use independent contractors, the IRS will want to verify they truly are an independent contractor and not

an employee posing as an independent contractor so you can avoid paying payroll taxes on that individual,” Legal River said.

So how do you do that? “If the worker in question has a business of his or her own and offers services to other businesses, the IRS will probably agree that the worker is indeed an independent contractor,” the legal team said. “If, however, you control where, when, and how the individual works, the IRS may consider that person an employee.” It’s important that you get this right. If you misclassify a worker, you might face increased taxes, interest, and penalties, which would make your mistake a particularly costly one.

Other Audit Triggers

There are many other audit triggers that have been identified by other experts and CPAs in recent years, such as cash income, high income, self-employment, sole proprietorship, and large deductions for business travel and entertainment.

Other attention-getters are claiming the home office deduction, itemizing deductions that seem unusually high in proportion to your income, employing a family member, family limited partnership, and using a tax preparer with a high error rate.

The IRS has an appeals system set up for people who do not agree with the results of an examination of their tax returns or with other adjustments to their tax liability.

(From Small Business Tax News, 2/10)

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Spotlight on Small 401(k)s

Recent IRS investigations into small 401(k) plans provide new insights. An examination of 50 top-heavy plans indicated problems such as failing to balance out contributions for lower-paid workers, excluding eligible workers, and failing to deposit employee contributions in time. Expect increased scrutiny of top-heavy 401(k) plans this year.

(From The Tax Strategist, 2/10)

IRS Gives Relief on Tips

Restaurant and bar owners can benefit from an extended IRS program. They can use a predetermined formula to determine tip amounts that must be reported on W-2s of servers. At least 75% of the affected employees must agree to the deal. The program, which was initially set to expire after 2009, will now last through 2011. (*IRS Revenue Procedure 2009-53*) Firms that sign up can avoid employer-only tip exams, which the IRS conducts to collect payroll taxes on unreported tips and to avoid having to audit each server.

(From The Tax Strategist, 2/10 and The Kiplinger Tax Letter, 12/11/09)

No Tax Concerns with EAPs

An employer can give a boost to employees going back to school by setting up an educational assistance plan (EAP). With an EAP, the first \$5,250 of qualified expenses paid on behalf of a participant is 100% tax free. The employer must establish a written plan for employees devoted exclusively to educational assistance. No more than 5% of the benefits can go to highly paid employees, officers, and shareholder-employees. Employees must be notified of the availability and terms of the program.

(The Tax Strategist, 2/10)

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