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To: Clients, Friends & Associates of Pro@ctive CPA
From: Mark Wyssbrod, Managing Member
Date: October 25, 2010
Re: IRS Audit Rates To Increase; Auditors Well Trained

Will the IRS auditor be smarter than the person who you hired to prepare your taxes? If you thought government workers weren't worth their salary, its time to re-think, well at least for the IRS auditors. In 2007 the Internal Revenue Service (IRS) hired MBA graduates. Over the past few years they have received a lot of good field experience. Now, the same agents are being trained to use QuickBooks (the accounting software most widely used by small business).

Audit rates From October 2008 to September 2010:

- C corporations with less than $10 million were audited 0.9% of the time
- C corporations with more than $10 million were audited 14.5% of the time
- S corporations and partnerships were audited 0.4% of the time
- Individuals were audited 1% of the time
- Individuals with Schedule C businesses with $25,000 to $100,000 in revenue were audited 1.9% of the time
- Individuals with Schedule C businesses with $100,000 to $200,000 in revenue were audited 4.2% of the time (and 3.2% audit rate for over $200,000)

What did the IRS find in prior years?

- In 2003 and 2004 (the "good" years of the economy) the IRS found 12% of S corporations in 2003 underreported revenue and this increased to 16% in 2004
- S-corporations with less than $200,000 in assets had a higher percentage of underreporting than large s-corporations
    - This is probably due to better internal controls, bank covenants, issuance of financial reports and accountability by passive shareholders

The IRS is now starting a new audit cycle for the tax years 2010 to 2012. The IRS is focusing on:

- Employment status
    - Are your employees allowed to work in the USA?
- Employee vs. independent contractor
    - Do you have contractors who should be employees?
    - If the IRS catches you, you will be liable for the social security and Medicare taxes
- Reasonable compensation (are you paying yourself enough?)
    - If you are paying yourself $10,000, but another company would have to pay you $100,000 you would be deemed to need to pay social security and Medicare taxes on the difference
- S corporation distributions vs. salary

  - IRS guidance shows you should have 50% of the monies you take out of your s-corporation as salary and the other 50% can be distributions
  - Shareholder distributions should be voted on and declared by the corporate board of directors
- Matching taxpayer identification numbers

You may feel that this is not fair, but the statistics show that small businesses were either too "aggressive" or were not following the rules in the past. This can be a dangerous mix since the taxpayer signs there return on penalty of perjury (and I hired a professional is not an excuse). The dangerous combination is tax professionals selling what most taxpayers want to hear that you can deduct an item which perhaps you shouldn't; tax preparers not keeping up with tax law changes; tax preparers not always graduating from college; and IRS agent with an MBA and experience.

We receive a lot of questions every year: Do you really need my back up documents? Do you really need to see my QuickBooks? Are you being too conservative? The answer is we take the time to ensure that our quality is high. This way if you do get audited you will not need to worry about a large adjustment or perjury charges. We take our weekends to read tax law updates and court cases so we can ask you the right questions to find areas where we can play offense, but also for areas were we need to play defense. We do not believe we are conservative, but we do believe we know and understand the tax rules and regulations and how they are enforced.

Please contact your Pro@ctive CPA Team should you have any questions at (770) 664-8583.

Citings

"Current Developments in S Corporations (Part I), Stewart S. Karlinksy, Ph.D., CPA, Hughlene Burton, Ph. D., CPA, The Tax Advisor, October 2010

"Tax Practice & Procedures", John L. Miller, CPA, The Tax Advisor, October 2010