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Stop Over-paying the IRS

By Justin Martin
Illustrations by Tavis Coburn

With the economy slowing and Washington threatening to boost audits of small businesses, it's time to rethink your tax strategy. Here are some commonly overlooked moves that could save you thousands.

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THERE ARE TWO PROVEN PATHS TO BUILDING wealth: You can increase the amount of money you make, or you can increase the amount of money you keep.

Chances are you devote abundant time and energy to the first strategy, meaning you're utterly consumed with developing new products or breaking into new markets. But the second path tends to get less consideration, particularly because one of the primary ways of keeping more money is paying lower taxes.

Taxes are painful not only to pay but to think about. Taxes are complex. Figuring out ways to shave your tax bill is not why you went into business.

But ignore the subject at your peril. In an effort to shore up a record deficit, the IRS is increasingly targeting small businesses for audits and has made no secret of the fact. Consider 2006, when the IRS audited nearly 18,000 small companies (which it defined as those with assets less than $10 million), up from 7,000 in 2004. At the same time, many small-business owners overlook key deductions and wind up needlessly giving away hard-earned cash.

To help you make the most of your tax-saving opportunities, *FSB* spoke with some of the nation's top experts on small-business tax issues, who offered smart moves that are often overlooked even by sophisticated entrepreneurs: under-the-rug tax credits, record-keeping tips, audit red flags, and more.

Read it—and reap.

Overlooked Deductions

START TALLYING THE WRITE-OFFS that are frequently missed by small-business owners and the list grows fast. There are no reliable statistics on just how much money is left on the table, but tax experts agree that many small businesses overpay by thousands of dollars. "When you get a visit from the IRS, they always say they are trying to make sure the tax payment is correct. I'll tell you this, I've never seen an agent give anything back," says Gerald Louviere, a tax partner in the Dallas office of PricewaterhouseCoopers.

Which means you should take every single write-off you're due—and what's available may surprise you. Here's a classic example: Small companies frequently miscategorize the cost of business-trip hotel stays as entertainment (50% deductible) rather than lodging (100%). The feds are only too happy to hang on to this windfall.

145%

Increase in the number of small businesses that were audited by the IRS in 2006 vs. 2004

Linda Rey, 41, is co-owner of Rey Insurance, a broker based in Sleepy Hollow, N.Y. The firm had $700,000 in revenues in 2007, and profits are growing at an average annual rate of 10%. Part of this success Rey attributes to savvy accounting advice. She and her partners (who also happen to be family members) hold a monthly dinner at a restaurant, which they treat as an offsite strategic planning meeting (100% deductible) rather than a business meal with a client (50%). Even with coffee and Dunkin' Donuts for the Friday morning meeting, she always

BIG BREAK The Reys (from left, Linda, Laura, and Frank), whose Sleepy Hollow, N.Y., firm insures this 1966 T-Bird, figured out how to double some deductions.

PHOTOGRAPHS BY ETHAN HILL

takes the full 100% deduction, while many companies wrongly file this under meals and take half. "I pay careful attention," says Rey. "Otherwise you end up giving a lot of money away."

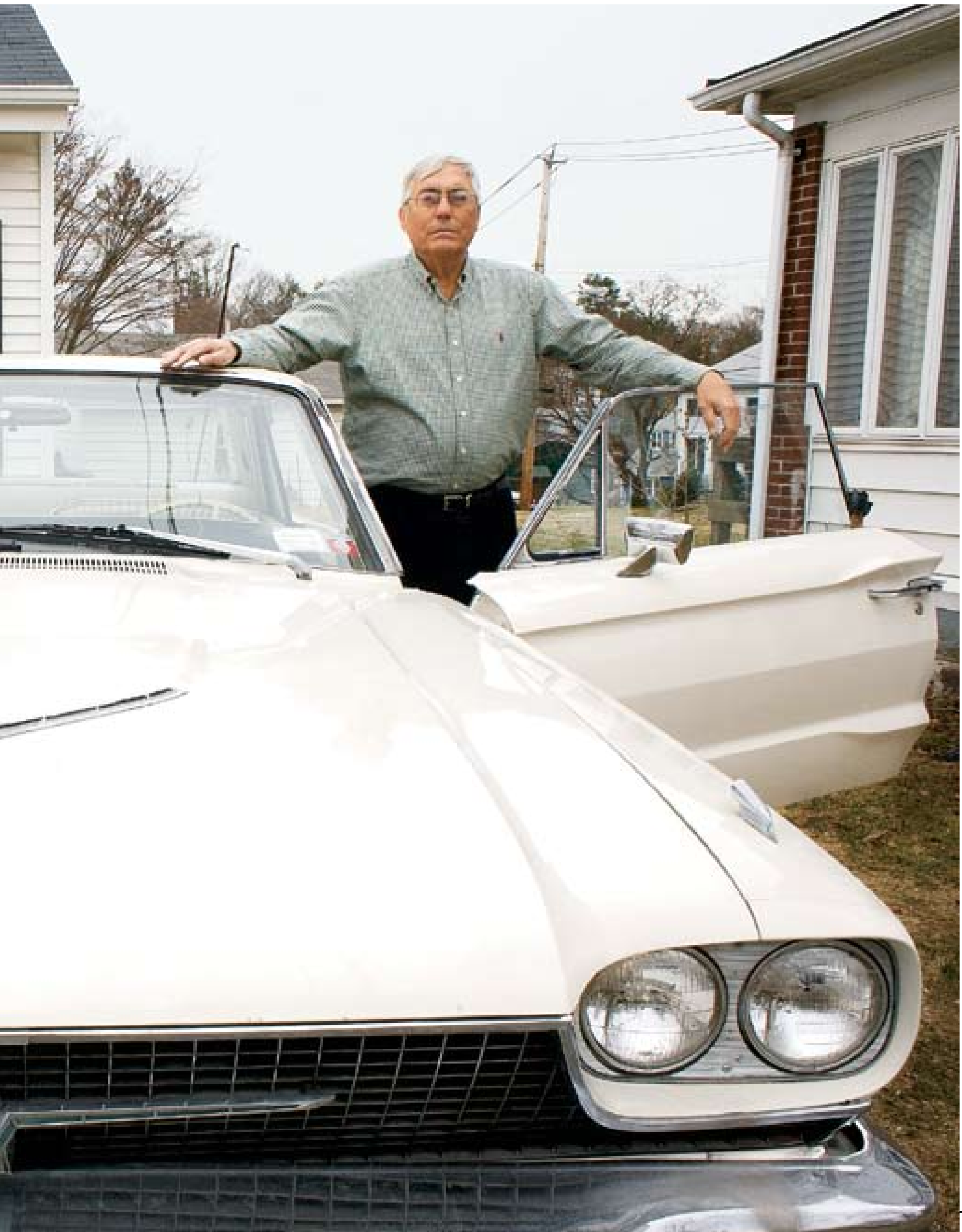
Esoteric-sounding write-offs are especially likely to get overlooked. Don't let their eye-glazing names fool you; often these tax breaks can deliver serious money. Do you manufacture a product in the U.S.? You may be eligible for the Domestic Production Activities Deduction. This write-off, introduced as part of the American Jobs Creation Act of 2004, is designed to reward companies that use U.S. labor. The maximum benefit is a 6% deduction on net income, though it rises to 9% in 2010. One caveat for small-business owners: The deduction cannot exceed 50% of the W-2 wages a company pays in a given year.

Manufacturers routinely take the domestic-production deduction, but the definition of production is sufficiently broad to cover some unlikely enterprises. For example, an architecture firm that designs a U.S. building might well be able to take the write-off. Ditto, the general contractor that executes the project. Software companies, farms and other agricultural businesses, and various mining operations are also eligible.

The domestic-production break is what's known as a zero-cash deduction, a particularly valuable type. With an ordinary

Fail to satisfy an IRS mail inquiry and an agent is likely to show up on your doorstep for a dreaded "field audit."

deduction you have to spend money—buy a drill press or take a client to dinner, say—to take a write-off. To claim the domestic-production write-off, all you have to do is, well, make stuff in the U.S. (or even partly in the U.S. to qualify for a partial deduction). There's no particular "event" to trigger the deduction, which is why it tends to get missed, says Steve Hurok, tax director of BDO Seidman in Woodbridge, N.J.



Tax Credits Are Golden

HERE'S A REASON TO INTRODUCE your accountant to even your most junior hires: Some of them may qualify you for generous tax savings. If you employ certain types of disadvantaged workers, you may be eligible for the lucrative Work Opportunity Tax Credit (WOTC). Congress spells out with extreme precision—and periodic updates—which workers qualify. Here are some examples: those between the ages of 18 and 39 who live in federally designated enterprise communities; ex-felons hired within one year of their release date; recently discharged veterans injured in the line of duty and out of work for six months or more.

The WOTC can lower your federal tax bill by as much as $4,800 per qualified worker during the first year of employment. However, the paperwork requirements are stiff. You need to complete the one-page IRS form 8850 on the day an employee is hired, and it must be mailed within 28 days of the person's start date. The WOTC is tailor-made for restaurants, retailers, and other industries that use a lot of unskilled labor. Yet tax experts note that these

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NEAT RECORDS Neil Mammen cleaned up the record keeping at his tech firm and boosted deductions 20%.

very businesses, especially small ones, hardly ever claim it.

Chances are you're ill inclined to immerse yourself in the IRS tax code, all 3.4 million words of it. So how do you make sure you're getting your rightful breaks? Press your tax preparer. If your CPA seems hazy or hesitant, consider hiring one who is more aggressive. How aggressive? You want to claim every penny you're due, but you don't want to risk the ire of the IRS. One good rule of thumb is to submit your prospective write-offs to the laugh test. "If it makes you snicker, chances are you've gone too far," says Hurok.

Organization Pays Dividends

WITH THE 15TH OF APRIL JUST WEEKS AWAY, MANY entrepreneurs are involved in a fevered annual exercise. 'Tis the season to reconstruct last year's expenditures. Owners and their bookkeepers are rifling through bewildering piles of dimly remembered receipts.

This is no way to live. Better to have a thorough system for recording expenses. "Have someone gather all receipts, annotate them when necessary, go through them regularly—once a week or month—and place them in well-labeled folders," urges Chet Burgess, owner of Brookwood Tax Service, based in Atlanta.

Vigorous record keeping will help you claim all the deductions you're due. It will also make you far better prepared for an encounter with the IRS, an increasingly likely event. A few years back, the IRS—under congressional scrutiny for overzealousness—trimmed its collection activities. Now the pendulum has swung back. Small businesses are notoriously sloppy record keepers, say accountants, making them easy marks for the IRS.

Neil Mammen, 45, is founder of Tentmaker Systems, a San Jose chip and circuitboard fabricator with eight employees. Recently he had a brush with the IRS that served as a wake-up call. In 2006 the agency contacted him about $30,000 worth of receipts. They assured him that this was not an audit ... yet. They just wanted clarification. Yes, the IRS often takes steps short of an audit, contacting business owners by mail. Fail to satisfy them and an agent will probably show up on your doorstep for a dreaded "field audit."

The IRS tends to look closely at things that seem like fun, such as cars and travel.

As a typical disorganized entrepreneur, Mammen found that he was woefully underprepared. Some of the receipts in question he found stuffed in a shoebox (no kidding). For others, he had to call vendors and ask for invoices. Others still required him to contact Visa to get originals at $10 a pop. (The IRS won't usually accept a credit card statement, though it will accept the digitized receipt copies that some card issuers send with each bill.) "It was scary, a nightmare, and it ate up a lot of my time," says Mammen. Ironically, those $10 receipt fees—along with any other costs incurred while satisfying an IRS inquiry or audit—are tax-deductible. In the end, the IRS did not deny any of his deductions.

Mammen has since found record-keeping religion. He uses a device called Neat Receipts to scan receipts directly into his PC. There he organizes them according to standard categories such as meals and office supplies. Then he backs the whole thing up in triplicate. Tentmaker Systems is profitable and had $1.6 million in revenues in 2007. After getting more organized, Mammen says, he was able to increase his deductions by about 20% this past year.

6%
The extra deduction from net income that you can take for products that you produce in the U.S.A.

A word to the wise: Even original receipts won't be enough to appease the IRS in certain cases. With entertainment, for example, you need to annotate the receipt, listing who was present and what business was discussed. "The IRS likes to look closely at things that seem fun," says Joseph Anthony, a tax preparer based in Portland, Ore. "Items like cars and travel and cellphones require enhanced substantiation."

This may seem like a hassle, but it pales in comparison with the kind of mayhem the IRS can stir up. If you are audited, typically agents will start with one year's tax return. Produce neatly organized receipts, and they may just go away. Arouse the IRS's suspicions, and it may start digging into other years.

At their discretion, agents can disallow questionable or poorly substantiated deductions. Meaning that a business owner has to pay back taxes. Throw in interest on the back taxes and penalties, and the tab can grow to be eye-popping. In rare instances, when the IRS suspects out-and-out fraud, it brings criminal charges that can result in jail time.

Get the Timing Right

WHAT DEDUCTIONS YOU'RE ABLE TO take is not the only consideration. It also matters when you take them. With taxes, as with so much else in business, timing is key.

Scott Kelley, 47, is a co-founder of Service Center Metals, based in Prince George, Va. His company makes aluminum rods, bars, and other pieces that get turned into everything from chopper handlebars to putter heads. Kelley's old-line manufacturing company bears scant resemblance to an accounting firm. Still, he thinks about tax strategy with the kind of precision most owners reserve for, say, pricing.

Service Center Metals uses expensive equipment. Writing off such major purchases usually takes years and must be done in accordance with depreciation schedules laid out by the IRS. With the help of a canny accountant, the company has found

AUDIT RED FLAGS

***FSB* consulted small-business tax experts to come up with a list of nine situations likely to draw unwanted attention from the IRS:**

NO PROFIT: Claiming business losses year after year or reporting a huge one in a single year will raise eyebrows.

VERY LOW REVENUES: The IRS may suspect your "business" is actually a hobby, in which case you aren't due any deductions.

A SLOPPY RETURN: In the age of TurboTax, the IRS doesn't look kindly on handwritten business returns.

A NEAT RETURN will trigger an audit if any sections are left blank.

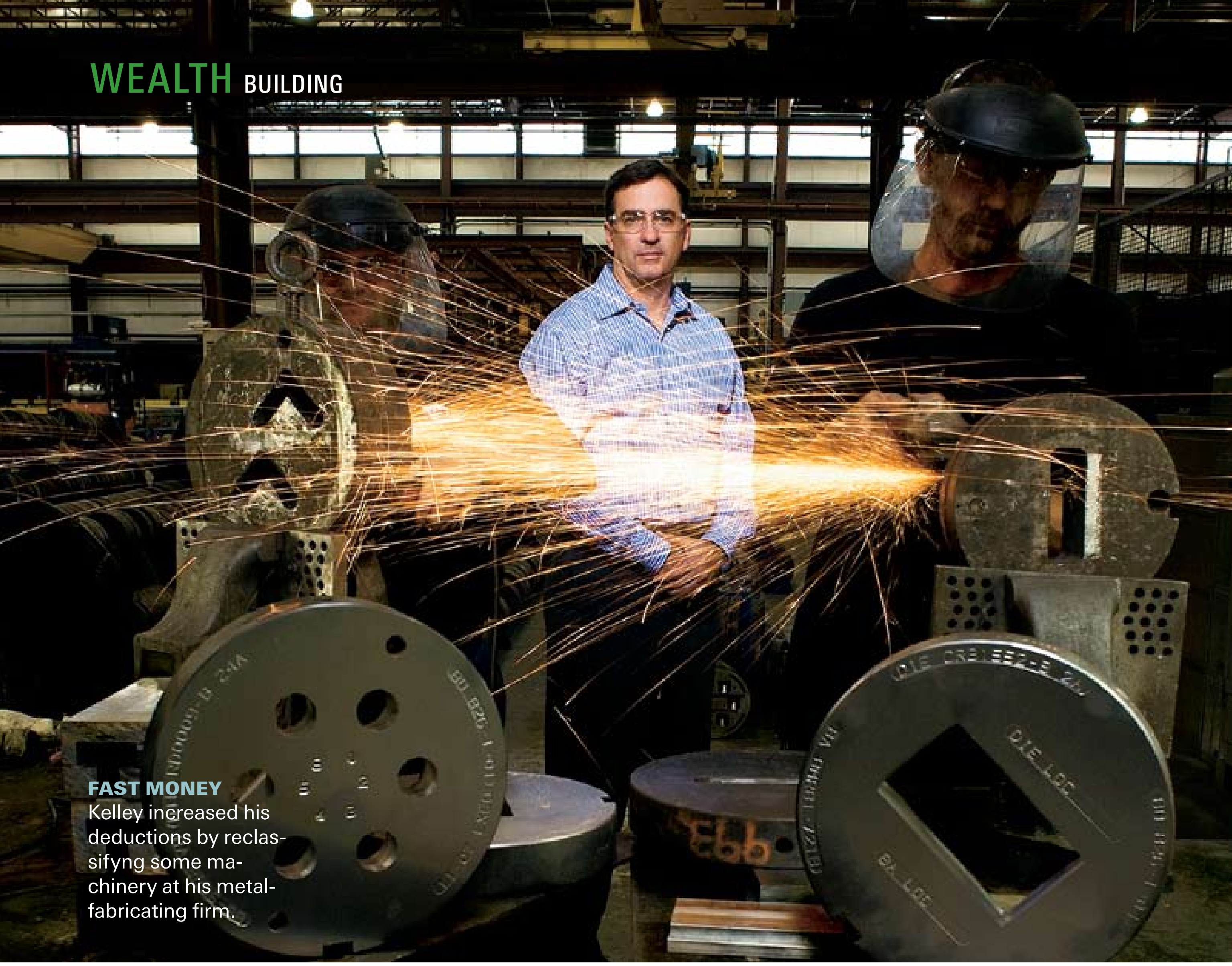
UNLIKELY DEDUCTIONS that are out of whack for your industry, such as a plumbing supply owner claiming lots of business travel, will raise a flag.

OUTSIZED DEDUCTIONS: Beware of excessive write-offs, like a business with $100,000 in sales claiming a $15,000 insurance premium.

TOO MUCH FUN: High deductions for travel, car, cellphones, or entertainment suggest you might be having too much fun and trying to claim it as a business expense.

FILING A BIG SCHEDULE C: As part of its small-business crackdown, the IRS is targeting sole proprietors. Schedule C filers with more than $100,000 in annual revenues were audited at a rate of 3.9% in 2006, up from 1.5% in 2000.

NICE ROUND NUMBERS are a dead giveaway that you're just making stuff up.



FAST MONEY Kelley increased his deductions by reclassifyng some machinery at his metal-fabricating firm.

ways to accelerate various deductions, which allows it to get more money more quickly.

In 2005, Service Center Metals purchased a $500,000 air compressor that typically would be considered part of its factory building, requiring a 39-year depreciation. The firm's CPA documented for the IRS that the compressor is actually used in the manufacturing process—not merely part of the building—making it possible to depreciate it over just seven years.

Service Center Metals owns two aluminum extrusion presses, one dubbed Elvis and the other the Boss, after Bruce Springsteen, whom Kelley has seen in concert more than 50 times. Pricetag for the presses: $11 million. The firm's CPA provided the IRS with careful documentation on how the presses are used, which allowed the company to write them off faster. All told, accelerated deduction yields hundreds of thousands of dollars to Service Center Metals each year and helps fuel the five-year-old company's growth: from $45 million in 2005 sales to $145 million in 2007. Profits in 2007 were up 40% over the prior year. "From the very beginning, we've tried to align our growth strategy with tax strategy," says Kelley. "Get money back quickly, use it to fund expansion and buy better equipment, make more money."

"From the very beginning, we've tried to align our growth strategy with tax strategy."

100%

The deduction many small businesses can take in year one for equipment

Your company may not be in the habit of buying heavy machinery. As it happens, there's a fantastic tax benefit for less capital-intensive businesses. It's called Section 179. For 2007 you can take an immediate write-off on as much as $125,000 worth of equipment. The definition of equipment is loose enough to include everything from computers to lighting fixtures to bookshelves. To qualify for the whole Section 179 deduction, your company must have made less than $500,000 in equipment purchases during the year. Above $500,000, the benefit phases out, dollar for dollar.

Say your company spent $5,000 in 2007 to purchase two new

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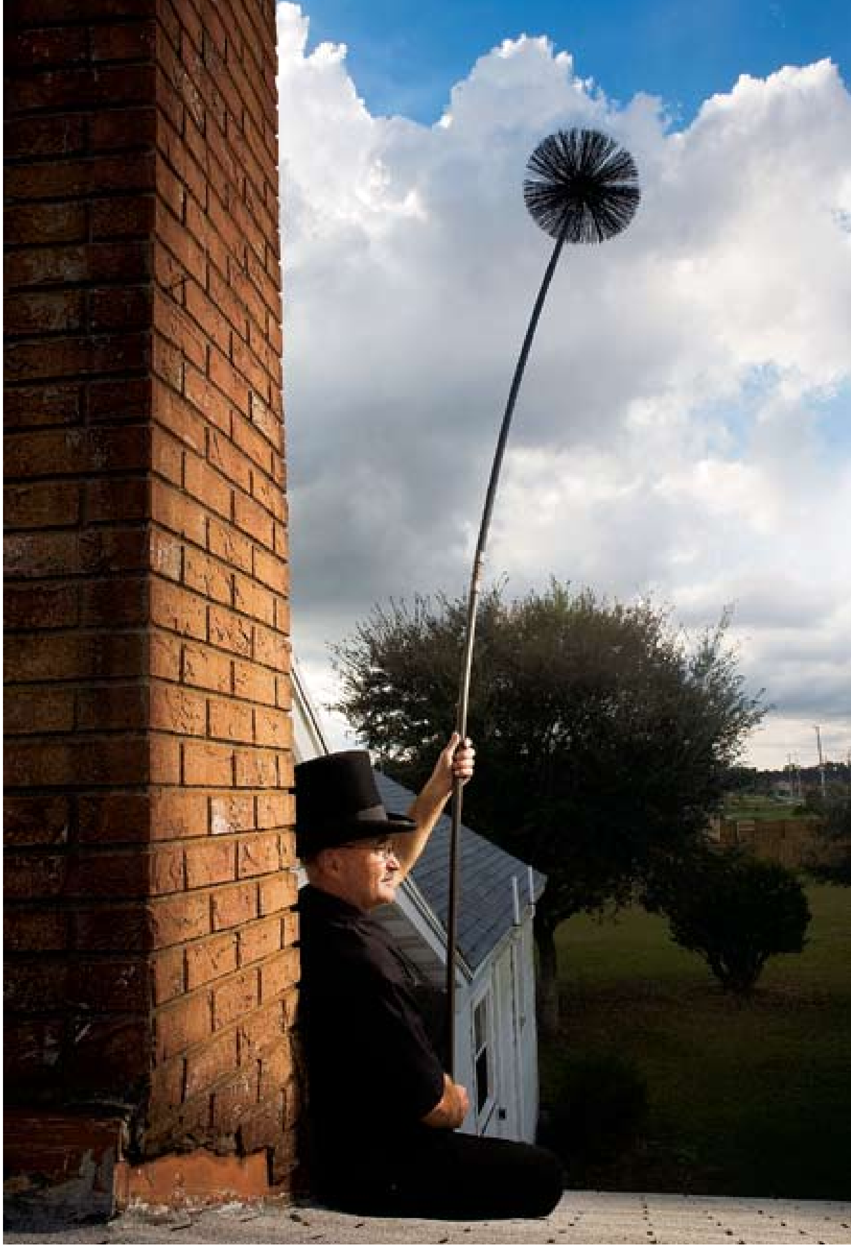

CLEANING UP Chimney sweep Dennis Verkest, at work in Valrico, Fla., maximized tax savings on his truck.

computers. Ordinarily the IRS requires you to write them off over five years. The IRS has an excruciating publication, No. 946, that lays out depreciation schedules for everything from tractors (three years) to tugboats (ten). But under Section 179, you could take the full write-off right away. "If I offered you $5,000 now or $1,000 a year for the next five years, which would you take?" asks Tom Ochsenschlager, VP of taxation for the American Institute of Certified Public Accountants, a professional association based in New York City.

Of course, sometimes it makes sense to spread a deduction out. If you've had a lackluster year, a big, immediate deduction may not make sense. If you are posting a loss, extra deductions are worthless in that year. In such cases, you might want to depreciate your purchases, reserving write-offs for future —and better—years.

Get Savvy on Transportation

VEHICLE DEDUCTIONS CAN BE PARTICULARLY tricky. Many owners wind up driving blind, say experts, unaware of how much money they're losing through poor tax planning. Not so Dennis Verkest, 55, the owner of A Chimney Sweep & More, based in Valrico, Fla. Because Florida homeowners don't use their fireplaces much, Verkest says he travels great distances to service the clients he has. He logs more than 15,000 miles a year in his Ford F-150 pickup. His solo operation will collect roughly $100,000 in revenues this year and is profitable.

Verkest arrives for jobs dressed all in black and sporting a traditional chimney sweep's top hat. "I don't wear tails," he says. "It's just too hot." Because his pickup is fairly new (2004 model year), conventional wisdom holds that Verkest should take the normal deductions. For a car or light truck, you get a write-off that changes from $3,060 in year one to $1,775 in the fourth year and onward until you've depreciated the purchase price. You can also deduct the cost of insurance, repairs, and—critically—gasoline.

By choosing the mileage rate, Verkest was able to increase his write-off on his truck by as much as $750.

But Verkest chose option two: standard mileage. You can't depreciate the cost of the car or write-off gas. Instead, you take a simple deduction based on how many miles you drive. For 2008 it's 50.5 cents a mile, up from 48.5 cents in 2007. By choosing the mileage rate, his CPA figures, Verkest will be able to increase his write-off by as much as $750 over the normal deduction. "I'll do anything to keep more money in my pocket," Verkest says.

By the way, you can also take a Section 179 deduction when you buy certain new or used vehicles. The write-off is $25,000 for a truck heavier than 6,000 pounds—a Hummer or Range Rover, say. At the same time you get to take accelerated depreciation on the purchase price starting at 20% the first year and then at varying rates thereafter.

Bottom line: If you have a newer car or don't drive so many miles, the normal deductions might be the way to go. If you drive a lot, standard mileage may be the ticket. In many cases you can switch from one kind of deduction to another. Switching can be wise as a car gets older and is due a smaller normal deduction. "Do the math each year," urges Barbara Weltman, author of *J.K. Lasser's Small Business Taxes*. "You can be surprised to find that you're losing money by taking the wrong vehicle deduction." Find the right one, and you've earned yourself a juicy tax cut. □

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