

NEW YEAR'S RESOLUTION: PREPARE FOR AN IRS AUDIT

As we begin a New Year, Irvine & Company is encouraging all of our clients to add one more item to their resolutions for 2014 – keeping better business records. In particular, we want to highlight the absolute necessity of keeping clean records in relation to travel expenses as these expenses are becoming an increased area of focus for the IRS. Keep in mind, any expense that looks personal in nature will also be subject to a higher level of scrutiny.

If you only remember one concept from this article please let it be the following:

The burden is always on the taxpayer to prove that they are entitled to the deduction.

For travel expenses, a higher level of documentation is required than with other business expenses (equipment purchases, payroll expenses, etc.). As such, whenever you incur an expense for business-related entertainment, meals, gifts or travel, your supporting documents must contain the following five items:

- **Date**
- **Amount**
- **Location**
- **Business Purpose**
- **Business Relationship**

We recommend collecting, or recording, your supporting documents near the time the expenses was incurred in order to improve the accuracy of your records. A timely-kept record has more value than a statement prepared later when generally there is a lack of accurate recall.

POOR RECORD KEEPING IS EXPENSIVE

Fun (or not so fun) fact: The IRS actually wins 80% of all audits, mainly because the taxpayers cannot show proper supporting documents.

It is not that the taxpayer isn't entitled to the deduction, but rather that the taxpayer was unable to produce the required documentation to support this deduction. It's not enough to have deductible expenses; you must also keep good records to be able to show that those deductions are legitimate. The responsibility to prove entries, deductions, and statements included on your tax returns is known as the burden of proof. You must be able to substantiate certain expenses.

If you are selected for an IRS audit, another benefit of keeping good records is that it can substantially reduce CPA fees. Our firm typically represents clients who are selected for audits. If we are requested to assist in gathering supporting documents to defend an expense, that time can add up quickly. With a clean set of records, we can focus our time advocating on your behalf.

THE "ORDINARY AND NECESSARY" TEST

Before continuing, let's step back and review some high-level guidance on what is required to deduct a business expense.

The IRS allows businesses to claim tax deductions for legitimate business expenses. These expenses are the current operating costs of running your business. To be deductible, the IRS says, a business expense must be both ordinary and necessary. An ordinary expense is one that is common and accepted in your field of business, trade, or profession. A necessary expense is one that is helpful and appropriate for your business, trade, or profession.

Generally, for an expenditure to be an ordinary and necessary business expense you must show a bona fide business purpose for the expenditure; there must be a clear relationship between the expenditure and your business. For example, if you sell wine, your membership in a cross country skiing club would be questioned as bona fide, but your membership in a wine industry trade group would not be questioned.

We always encourage our clients to use common sense when recording expense related to their business. Repeat the mantra “ordinary and necessary” and it will go a long way to assist you in understanding what is acceptable by the IRS. If you have any specific expense questions, please feel free to give us a call to discuss.

FIVE ITEMS TO DOCUMENT FOR BUSINESS EXPENSES

As mentioned above, it's not enough to have deductible expenses. You must also keep good records to be able to show that those deductions are legitimate. In order to be able to deduct business expenses and reduce your business tax bill, the law says your business must "maintain records sufficient to substantiate the amounts and purposes of deductions claimed."

Supporting documents related to travel, meals & items are investigated closer by the IRS in order to ensure they are not personal expenses. It is important to keep relevant documents because they support the entries in your books and on your tax return. The five facts that need to be recorded were previously mentioned but will be included again with additional clarification:

- **Date** - The date the expense was incurred will usually be listed on a receipt or credit card slip; appointment books, day planners, and similar documents have the dates preprinted on each page, so entries on the appropriate page automatically date the expense. It is important to keep the document that indicates the date the expense was actually paid, this will help to substantiate that not only was the expense incurred but that it was also paid.
- **Amount** - How much you spent, including tax and tip for meals. Always separate amounts for charges such as lodging, meals, and telephone calls. The IRS can, and will, disallow the total expense if these items are not separated. This is mainly due to the fact that meals & entertainment expenses only receive a 50% deduction as opposed to lodging which is entitled to a 100% deduction.
- **Location** - The nature and place of the entertainment or meal will usually be shown by a receipt, or you can record it in an appointment book.
- **Business Purpose** - Show that the expense was incurred for your business — for example, to obtain future business, encourage existing business relationships, and so on. What you need to show depends on whether the business conversation occurred before, during, or after entertainment or a meal.
- **Business Relationship** - If entertainment or meals are involved, show the business relationship of people at the event — for example, list their names and occupations and any other information needed to establish their business relation to you.

As part of your process in submitting expenses for the business, always document the above items and you should feel confident that you are ready for any sort of audit request that comes your way. A defined record keeping process is key to ensuring that all expenses have the supporting documentation required by the IRS.

ORGANIZATION GETS YOU BROWNIE POINTS

The organization of records goes a long way in influencing an IRS agent. Being organized will help the audit process to move along more smoothly and quickly. This allows the IRS agent to more easily perform their job, and portrays you in a more positive light. Put yourself in an IRS agents' shoes and think about who you would

give the benefit of the doubt to – the person with indexed binders of supporting documents or the person with the shoebox full of receipts?

Using this mindset, work with your bookkeeper or accounting department to establish a systemized approach to organizing your supporting documentation. We have found that establishing a process of getting your support in order will also help ensure that you are not missing any necessary documents. An additional benefit is that this system will provide increased clarity in processing employee expense reimbursement. Requiring the five facts as discussed above to be included in reimbursement forms can help to ensure the expense incurred was not for personal benefit but rather to support the business.

By keeping your documents organized and collected in a safe place, you will be able to address IRS agent's requests with confidence and efficiency. Consider these recommendations as another way to protect your assets, losing out on deductions is an erosion of your assets and therefore a threat to your business.

COMMON MISCONCEPTIONS

To wrap up the conversation regarding good record keeping we thought it would be beneficial to highlight some common misconceptions that we have heard over the years. Whether mentioned by a neighbor, a family member or an "accounting" website, please take note of the following:

- **Credit card statements provide enough support** - Credit card statements are not enough to substantiate an expense in an IRS audit. It can be used as part of the supporting documents to refer to date, location and time of payment but it does not provide the support needed to substantiate the business purpose. In fact, relying solely on credit card statements can cause more problems because then the auditor has that record of other expenses and could possibly require additional documentation to support those expenses.
- **QuickBooks file provide enough support** – While we are glad you're recording expenses in your accounting software, the IRS does not recognize your general ledger as enough support for your expense. See the five facts above regarding what is needed to substantiate a request.
- **Bad documentation in one year won't affect other years** – If the IRS determines your record keeping to be substandard in the year under examination they have every right to exam prior or future years to determine if there is additional tax liability. Once the IRS believes your lack of record keeping to be negligent they tend to follow up with additional examination requests. This is a very bad situation for a business to find itself.
- **Missing a few supporting documents is no big deal** – During an IRS examination an auditor can choose a random selection of expenses for the taxpayer to substantiate. If, for example, they discover 20% of their sample size is not supportable, they have the right to extrapolate this percentage across the entire account under review. This can result in the disallowance of expenses that you actually have the proper supporting documents for but the auditor has made a judgment call to test no further and disallow the extrapolated amount due to negligence.

CONCLUSION

Nothing offends a CPA more than a perfectly acceptable deduction being disallowed due to poor record keeping. We know how hard our clients work on a daily basis and want nothing but success for them. Unfortunately, too many businesses don't take the time to emphasize the importance of good record keeping and are paying the price for it. Following the recommendations above will help you to feel more confident if the IRS ever comes knocking.

If you'd like to learn more about recommended best practices, or go through a mock IRS audit, please contact us to discuss further.