NFIB GUIDE TO TAXES

2014

WHAT'S INSIDE

How to Lower Your Taxes and Avoid Audits

NFIB
The Voice of Small Business.®

Dear NFIB Member:

Owning your own business is a dream-come-true, the fruition of hard work, imagination and determination. For the sweat and the tears, you're rewarded with the daily joys of doing what you love.

With the dream, however, comes responsibility, the most significant of which may very well be dealing with the Internal Revenue Service. As a small business owner, you have likely come to the realization that income tax issues are far more complex and crucial to the owners of small businesses than they are to people with regular jobs.

Because taxes are such a cumbersome part of doing business, this guide was developed for you by the NFIB Small Business Legal Center. The Small Business Legal Center is the voice for small business in the nation's courts and a legal resource for small business owners nationwide. Simply put, the Legal Center litigates and educates on behalf of small business.

The *NFIB Guide to Taxes* has been compiled to help you navigate the tricky waters of filing taxes. From "Understanding the Individual AMT," to "Common Deductions Used by Small Businesses" and "Avoiding an Audit," we hope to supply you with information that helps legitimately reduce your share of taxes, thus allowing you to keep more of your hard-earned money.

Within the pages of this guide, you'll find easy-to-understand information about the AMT and whether or not it applies to you, answers to questions about business deductions and more. Finally, we devote an entire chapter to the word that breathes fear into all taxpayers, the audit. Becoming informed about audits is the first step in avoiding one. We'll let you know how taxpayers are selected for audits and what you can do to steer clear of audit "hot buttons," or red flags that draw the attention of the IRS to your return.

Essentially, with taxes, knowledge is key. At NFIB, we're happy to be part of your tax solution. The *NFIB Guide to Taxes* is just another way we're working to promote and protect your right to own, operate and grow your business.

Best Regards,

Dan Danner

Dan Danner
NFIB President and CEO

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Disclaimer

This publication is not designed as a substitute for legal tax advice. Rather, it is designed to help inform persons about the basic provisions of the federal tax law. Future changes in laws cannot be predicted and statements in this product are based solely on the laws in force on the date of publication. It is wise to consult with your tax advisor for assistance in proper tax planning practices for your individual situation.

ABOUT NFIB GUIDE TO TAXES

Welcome to our exclusive series of publications written to provide practical solutions to the challenges faced by small business owners. The *NFIB Guide to Taxes* has been compiled to assist you in dealing with a system that is both costly and complex.

This Guide addresses three important areas related to owning a small or independent business: the Alternative Minimum Tax (or AMT), common deductions employed by small businesses and information on how to avoid an audit.

ABOUT NFIB

The National Federation of Independent Business is the nation's leading small business association, with offices in Washington, D.C., and all 50 states. NFIB's powerful network of grassroots activists sends their views directly to state and federal lawmakers through our unique member-only ballot, thus playing a critical role in supporting America's free enterprise system.

NFIB GUIDE TO TAXES

OVERVIEW

The *NFIB Guide to Taxes* has been compiled to assist small business owners with one of the most cumbersome and financially draining elements they face in business—taxes. At NFIB, we know that high taxes and complexity stand in the way of your growth. For this reason, we fight to minimize this dual tax burden faced by small business owners. We've had success, and we vow to continue the fight. With the *NFIB Guide to Taxes*, we are supplementing our quest to make changes to the tax code with information you can use to lower your taxes and avoid audits.

Common Deductions Used by Small Businesses

Tax deductions can help small business owners to improve their cash flow. However, many owners wind up paying more taxes than they owe by overlooking allowable deductions. While tax experts warn that deducting too much can get your business in big trouble, taking legitimate deductions is simply smart business.

Small business owners need to be tax-wise throughout the year, not just during tax season. This section of *NFIB Guide to Taxes* assists you with taking deductions, from straightforward business expenses like office rent and salaries, to more complicated deductions such as expensing and depreciation.

Avoiding an Audit

The word "audit" strikes fear in the hearts of those who hear it. After all, audits are time-consuming, costly propositions. No one wants to tangle with Uncle Sam if they don't have to; however, being a small business owner can put you at greater risk for a random audit.

Fortunately, there are steps you can take to avoid being the target of an audit. "Avoiding an Audit" exposes 18 IRS audit "hot buttons;" from simple things, including steering clear of round numbers on deductions and avoiding handwritten returns, to tips like knowing when to file if you are getting a refund, versus when to file if you owe.

"Avoiding an Audit" is a must-read for small businesses. The knowledge you accumulate should help you run your business in such a way that an audit is less likely. However, should an audit ever occur, you'll be better organized and better prepared to deal with it.

Understanding the Individual AMT

The individual AMT is a remarkably complex provision in a tax code not known for its clarity. It requires taxpayers to calculate their taxes twice, and then pay the larger amount. Originally designed to ensure that wealthy Americans pay a fair share of their income in taxes, the AMT was never fully adjusted for inflation, and now many middle-class taxpayers and small business owners find themselves subject to the tax.

Congress finally passed permanent relief from the AMT, increasing the exemption amount so that it hits fewer tax payers.

COMMON DEDUCTIONS USED BY SMALL BUSINESSES

Some of the more straightforward business expenses include telephone, utilities, office rent, salaries, legal and accounting expenses, professional services, dues, bank fees and interest on business debt, and subscriptions to business publications. More complicated deductions are described on the following pages.

Common Deductions Used by Small Business

As a general principal, in order for business operating expenses to be deductible, they must be:

- Ordinary and necessary
- A current expense
- Directly related to your business, and
- Reasonable in amount (an amount is reasonable unless there are more economical alternatives).

Entertainment

Currently, most businesses can deduct up to 50 percent of entertainment expenses. If you entertain clients to promote your business, it is a good idea to maintain a log for deductible entertainment expenses.

Use a standard appointment calendar to write down whom you were entertaining, the nature of the business, where you were and how much you spent. Contrary to popular belief, you do not need receipts for entertainment expenditures under $75, but you must maintain a log. However, having receipts for expenditures under $75 helps establish your credibility.

In certain instances you can even claim business-related entertainment at home. As a precaution, have clients or prospects sign a guest log. If you prepare a meal or serve drinks, your expenses are deductible as part of the cost of doing business.

For entertainment expenses, the following five elements should be recorded:

1) The amount of expenditure
2) The date of expenditure
3) The location and type of entertainment
4) The reason for entertainment and the nature of the business discussion that took place
5) The occupation of the person being entertained

Travel

Generally, all expenses incurred during business travel are deductible as ordinary and necessary business expenses. The type of expense you can deduct depends on the facts and your circumstances. Oftentimes, deductible business travel expenses will include the cost of airline tickets, taxi fares, baggage, shipping, rental car, overnight lodging and other selected expenses.

In addition, you can deduct the travel expenses of an employee, partner or customer who travels with you as long as it is for a bona fide business purpose, and the travel expenses are otherwise deductible.

Just as you do with entertainment expenses, you should use a log, diary, notebook or any other written record to keep track of your travel expenses.

When you combine personal travel with business, the expenses must be pro-rated between the two, with the exception that the full cost of the round-trip airfare is tax-deductible as a business expense as long as this is primarily a business trip. If the trip is primarily personal, then the travel expenses are not deductible unless they are business-related expenses. The amount of time during the trip spent on business activities compared to personal activities is a major factor in determining if the trip is primarily business or personal.

NOTE: If you have one expense that includes the costs of meals, entertainment and other services (such as lodging or transportation), you must allocate that expense between the cost of meals and entertainment and the cost of other services. You must have a reasonable basis for making this allocation. For example, you must allocate your expenses if a hotel includes one or more meals in its room charge.

Meals

Normally, meals are limited to 50 percent of the cost. Meals can be deducted for travel or business-entertainment purposes.

You can figure your meals expense using either of the following methods:

- **Actual cost:** Use the exact amount and take 50 percent. Keep your receipts.
- **Standard meal allowance:** This is a set federal rate that can be used by self-employed individuals. Consult the IRS Publication 1542 for your local standard rate on meals and incidental expenses (M&IE) under the Per Diem Rate Tables (www.irs.gov/publications/p1542).

TABLE 1-1. TRAVEL EXPENSES YOU CAN DEDUCT (FROM IRS PUBLICATION 463)

This chart summarizes expenses you can deduct when you travel away from home for business purposes.

IF you have expenses for...	*THEN you can deduct the cost of...*
Transportation	Travel by airplane, train, bus or car between your home and your business destination. If you were provided with a ticket or you are riding free as a result of a frequent traveler or similar program, your cost is zero. If you travel by ship, see Luxury Water Travel and Cruise Ships (under Conventions) for additional rules and limits.
Taxi, commuter bus and airport limousine	Fares for these and other types of transportation that take you between: 1) The airport or station and your hotel. 2) The hotel and the work location of your customers or clients, your business meeting place or your temporary work location.
Baggage and shipping	Sending baggage and sample or display material between your regular and temporary work locations.
Car	Operating and maintaining your car when traveling away from home on business. You can deduct actual expenses or the standard mileage rate, as well as business-related tolls and parking. If you rent a car while away from home on business, you can deduct only the business-use portion of the expenses.
Lodging and meals	Your lodging and meals if your business trip is overnight or long enough that you need to stop for sleep or rest to properly perform your duties. Meals include amounts spent for food, beverages, taxes and related tips. See Meals for additional rules and limits.
Cleaning	Dry cleaning and laundry.
Telephone	Business calls while on your business trip. This includes business communication by fax machine or other communication devices.
Tips	Tips you pay for any expenses in this chart.
Other	Similar, ordinary and necessary expenses, such as transportation to or from a business meal, public stenographer's fees, computer rental fees, and operating and maintaining a house trailer.

Capital Assets

Business property that you reasonably expect to last for more than one year is a capital asset. This typically includes items such as office furniture, computer equipment, vehicles, books, and medical, dental or other specialized equipment. It is very wise to properly account for all capital assets.

There are two basic ways you can deduct capital assets:

BY DEPRECIATING

Property can be depreciated if:

- You own it.
- You use it in your business.

- It has a useful life (the length of time that a depreciable asset is expected to be useable) that extends beyond the year it is placed in service (the year you start using it).
- The useful life is determinable (wears out, decays, becomes obsolete).
- It is not used and disposed in the same year.

When you depreciate an asset, you can deduct some of the cost each year over the asset's useful life. The most common method for depreciating assets placed in service after 1986 is the Modified Accelerated Cost Recovery System. To learn more about MACRS, consult IRS Publication 946 (www.irs.gov/publications/p946).

NEW TANGIBLE PROPERTY REGULATIONS

In 2013, the IRS issued new regulations that change when a business owner can deduct the cost of acquiring tangible property and when that property has to be capitalized and depreciated. The regulation contains a number of safe harbors for small-business owners, including the ability to deduct items that cost $500 or less. Because these changes are complicated, it is important to discuss with your accountant whether they apply to your business. The regulations do not change other expensing rules, such as those under Section 179 discussed in the next section.

BY EXPENSING

Under Section 179 of the Internal Revenue Code you can deduct up to $25,000 of your business equipment expenses in the year of purchase.

The property must be:

- Tangible personal property (not real property) such as machinery, office equipment or livestock
- Acquired for business use
- Acquired by purchase, and
- Must not be land, land improvements or certain excepted property.

There are many rules that limit a Section 179 deduction. Consult IRS Publication 946, mentioned earlier, to learn more details about Section 179 expensing. *In certain cases, you may be better off by taking regular depreciation.* This is best resolved by conferring with a professional who understands your tax needs and the depreciation tax rules.

NFIB Federal Public Policy Efforts: NFIB continues to fight to increase the small business expensing limit, which was as high as $500,000 last year. The ability to deduct certain costs for improvements to real property was also temporarily included in Section 179, and NFIB has made the inclusion of real property expenses a priority as well. Ideally, these increased expensing levels would be made a permanent part of the tax code.

Special Disaster Depreciation Rules: There are special depreciation rules for those in disaster areas, such as Katrina. Unfortunately, these disaster area depreciation provisions include pitfalls for the unknowledgeable. Again, it is best to consult with a tax professional to determine your eligibility.

IRS Form: Use IRS Form 4562 and file Schedule C if you plan to claim depreciation or Section 179 deductions.

Catch-Up Depreciation

IRS regulations allow a "catch up" election for unclaimed depreciation and amortization in the year of sale for years ending on or after December 30, 2003. If you determine that you have taken incorrect depreciation on your assets in prior years, you may be able to take advantage of this "catch up" election without amending past business or personal returns.

Inventories

If you make or buy goods to sell, you can deduct the cost of goods sold from your gross receipts on Schedule C. However, to determine these costs, you must value your inventory at the beginning and end of each tax year. Opening inventory will usually be identical to the closing inventory of the year before. You must explain any difference in a schedule attached to your return. The following methods, described below, are those generally available for valuing inventory:

1) Cost
2) Lower of cost or market
3) Retail

To calculate your cost of goods sold, you will need to fill out lines 35 through 42 on Schedule C. For more information on inventories, consult IRS Publication 538 (http://www.irs.gov/publications/p538/).

Home Office

If you work out of your home, consult with your tax advisor to determine whether a home-office deduction makes sense for you.

To claim expenses for business use of your home, you must show that you use your home office exclusively and regularly as your principal place of business.

1) Exclusive: The office must be used for no purpose other than your business. Two exceptions to this are if you are storing inventory or using a room to provide daycare.

2) Principal place of business: This is where you conduct administrative or management activities, exclusively and regularly, for your business.

If you have another office somewhere else, you may be able to deduct the cost of a home office as well, if, for instance, you meet with clients at your home office. Employees must also be using the home office for the convenience of their employer.

Allowable Deductions: Home-office expenses that are eligible for deduction include all normal office expenses plus interest, taxes, insurance and depreciation (you must claim the depreciation) on the portion of your home used exclusively for business. You can deduct business-related telephone charges, such as long distance charges, made from your home number, as well as business equipment and supplies.

Eligibility is based on the percentage of your home used for business and whether the expenses are direct, indirect or unrelated.

Limits to Home Office Deduction: If your gross income from the business use of your home equals or exceeds your total business expenses (including depreciation), you can deduct all your business expenses related to the use of your home.

If the business does not have enough profit to absorb the home-office deduction, you can deduct the excess from income earned on a 9-to-5 job, if you still have one, or from your spouse's income, if you file a joint return. Or, you may carry the excess expenses to the following year.

In addition, there are limits to deductions a shareholder may take for home-office expenses when receiving rent from the shareholder's C or S corporation.

Business Percentage: Allocation of home-office expenses is generally made on the basis of the ratio of square footage used exclusively for business to total square footage of the residence. You must also prove that the part of your home you use as your home office — which can be just a portion of a room as opposed to an entire room — is used only for business. Take photographs of your home office. But, having personal items captured in the picture may cause you to lose your claim that it is solely used for business.

The home office determination is important for maximizing your business travel expenses. If your home office is your residence, then travel away from the home office can be business travel. This reduces the non-deductible commuting costs since your residence and tax home (home office) are the same place.

TABLE 1-2. TYPES OF EXPENSES (HOME OFFICE DEDUCTION)

Expense	*Description*	*Deductibility*
Direct	Expenses only for the business part of your home. **Examples:** Painting or repairs in the area used for business.	Deductible in full.* **Exception:** May be partially deductible in a daycare facility.
Indirect	Expenses for keeping up and running your entire home. **Examples:** Insurance, utilities, and general repairs.	Deductible based on the percentage of your home used for business.*
Unrelated	Expenses only for the parts of your home not used for business. **Examples:** Lawn care or painting a room not used for business.	Not deductible.

*Subject to the deduction limit, discussed earlier.

Simplified Home Office Deduction

In 2013, the IRS created a new simplified home office deduction. Taxpayers may claim it on a year-by-year basis. The simplified deduction sets the allowable deduction for home office expense at $5 per square foot for a maximum yearly deduction of $1,500. This simplified deduction avoids the need to calculate the ratio of square footage used for business to total square footage. However, the standard home office deduction is still available and there may be situations where it is more advantageous to use it.

Outside Office

An outside office that you rent or own presents many opportunities for tax deductions. Virtually all your outside office expenses are deductible, including rent, utilities, insurance, repairs, improvements and maintenance. Capital improvements may need to be depreciated over the life of the underlying property. The tangible property regulations discussed above also create new rules regarding what improvements need to be capitalized.

Health Insurance

Corporations can deduct health insurance as an ordinary and necessary business expense.

If you are self-employed and have a net profit for the year, you may be able to deduct up to 100 percent of the amount paid for medical, dental, and qualified long-term care insurance on behalf of yourself, your spouse and dependents. In order to qualify for this deduction you must be one of the following:

- A self-employed individual with a net profit reported on Schedule C, C-EZ, or F.
- A partner with net earnings from self- employment reported on Schedule K-1 (Form 1065), box 14, code A.
- A shareholder owning more than 2 percent of the outstanding stock of an S corporation with wages from the corporation reported on Form W-2.

The insurance plan *must be established under your business.* You may be allowed this deduction whether you paid the premiums yourself or your partnership or S corporation paid them and you included the premium amounts in your gross income. Generally, you will take the deduction on line 29 of Form 1040. In other words, this expense is deducted from your regular gross income as an above-the-line deduction (arriving at your gross adjusted income), regardless of whether you itemize.

Self-employed individuals cannot deduct health insurance from self-employment taxes (12.4% for Social Security and the 2.9% Medicare tax). This places them at a disadvantage compared to employers, who can deduct the cost of employee provided health insurance from their portion of Medicare and Social Security taxes. The 2010 Small Business Jobs Act temporarily allowed self-employed business owners to deduct the cost of health insurance from their self-employment taxes, but the provision has never been reenacted. NFIB is working to reinstate this parity for self-employed business owners.

In many solely owned businesses, the owner of the business will *purchase health insurance in his or her own name versus the name of the business. The type of entity may greatly affect where this insurance premium expense may be deducted.*

A self-employed individual who is a sole proprietor and who purchases health insurance in his or her own name is still eligible to claim a deduction for health insurance premiums against his or her individual gross income (an above-the-line deduction). Alternatively, sole proprietors may be able to take the deduction on Schedule C, instead of on Form 1040, if they have a legitimate working spouse in their business and the policy is on the working spouse. The policy can cover the working spouse, the children, and the sole proprietor, and still be eligible for the Schedule C deduction.

In contrast, the IRS recently determined that if the business is operating as an S corporation where the owner is the sole shareholder and sole employee and he purchases the health insurance in his own name, he will not be able to take the above-the-line deduction on Form 1040 (S corporations do not file Schedule C). The shareholder can still deduct the health insurance as an itemized deduction, which can be deducted if the premiums exceed 7.5 percent of his adjusted gross income.

This situation may seem unfair, and NFIB is consulting with the IRS on this very issue. However, unless the IRS reverses its position, it is wise to purchase the health insurance plan under the S corporation's name in order to enjoy the full self-employed deduction.

It is also important to note that an above-the-line deduction is not allowed for any calendar month in which the shareholder is eligible to participate in any subsidized health plan maintained by any other employer of the shareholder or of the spouse of the shareholder.

Any taxpayer who itemizes deductions and does not claim 100 percent of self-employed health insurance on his or her return (maybe because of the limitation on income) may be able to deduct the premiums if the expenses exceed 7.5 percent of his or her adjusted gross income.

Other Deductible Insurance Premiums

You generally can deduct other premiums you pay for the following kinds of insurance related to your trade or business:

- Insurance that covers fire, storm, theft, accident or similar losses.
- Credit insurance that covers losses from business bad debts.
- Group hospitalization and medical insurance for employees, including long-term care insurance.
- Accident insurance.
- Liability insurance.
- Malpractice insurance that covers your personal liability for professional negligence resulting in injury or damage to patients or clients.
- Workers' compensation insurance set by state law that covers any claims for bodily injuries or job-related diseases suffered by employees in your business, regardless of fault.
- If a partnership pays workers' compensation premiums for its partners, it generally can deduct them as guaranteed payments to partners. Remember that if an S corporation pays workers' compensation premiums for its 2 percent shareholder-employees, it generally can deduct them, but must also include them in the shareholder's wages.
- Contributions to a state unemployment insurance fund are deductible as taxes if they are considered taxes under state law.
- Overhead insurance that pays for business overhead expenses you have during long periods of disability caused by your injury or sickness.
- Car and other vehicle insurance that covers vehicles used in your business for liability, damages and other losses. If you operate a vehicle partly for personal use, deduct only the part of the insurance premium that applies to the business use of the vehicle. If you use the standard mileage rate to figure your car expenses, you cannot deduct any car insurance premiums.
- Life insurance covering your officers and employees if you are not directly or indirectly a beneficiary under the contract.
- Business interruption insurance that pays for lost profits if your business is shut down due to a fire or other cause.

Automobile Expenses

Deductions can be calculated in one of two ways: either by using the IRS standard mileage rate or the actual operating expenses related to your business, whichever is greater. This deduction is available to you whether you or your business owns or leases the car.

To limit vehicle lease expenses so that they are comparable to expenses for owned vehicles, you *may have to reduce your deduction for your lease payment* if the value of your leased car is above a certain fair market value. This is designed to prevent taxpayers from avoiding the luxury auto depreciation limits. Consult IRS Publication 463 (www.irs.gov/publications/p463) for more details.

IRS Standard Mileage Rate: For 2014, the deductible rate for business-related automobile mileage will be 56 cents a mile. To calculate the deduction, multiply the rate by the exact business mileage. If you claim accelerated depreciation, then you may not subsequently claim the standard mileage rate.

Actual Operating Expenses: Typical deductions under this approach include gasoline, maintenance, insurance, repair costs, depreciation, lease payments, registration costs, washes and tires. Add together your total expenses and multiply it by the fraction of business miles over total miles driven.

Ask your tax advisor to help you with the calculations to figure out which method makes the most sense for you.

Unreimbursed Employee Expenses

You can deduct only unreimbursed employee expenses that are paid or incurred during your tax year for carrying on your trade or business of being an employee, and they must be ordinary and necessary. *But you are much better off having the business reimburse you directly for these expenses.* The unreimbursed expenses only become deductible if you itemize and only to the extent they exceed 2 percent of your adjusted gross income. *Worse, they are not allowed whatsoever as a deduction in calculating your alternative miminum taxable income.*

However, if you are advancing expense money and do not substantiate your expenses in a timely manner, the entire amount is added to your reported income. In addition, if some employees are given per diem amounts greater than the federal per diem rates and they fail to document their expenses, the *entire amount of all allowances paid by the employer to all employees* (not just those being advanced more than the federal per diem rate) must be reported as wage income.

You may be able to deduct the following unreimbursed employee expenses:

- Business bad debt of an employee
- Business liability insurance premium
- Damages paid to a former employer for breach of an employment contract
- Depreciation on a computer or cellular telephone your employer requires you to use in your work
- Dues to a chamber of commerce if membership helps you do your job
- Dues to professional societies
- Education that is work-related
- Educator expenses that are more than you can deduct on Form 1040, line 23
- Home office or part of your home used regularly and exclusively in your work
- Job-search expenses in your present occupation
- Laboratory breakage fees
- Legal fees related to your job
- Licenses and regulatory fees
- Malpractice insurance premiums
- Medical examinations required by an employer
- Occupational taxes
- Passport for a business trip
- Repayment of an income aid payment received under an employer's plan
- Research expenses of a college professor
- Rural mail carriers' vehicle expenses
- Subscriptions to professional journals and trade magazines related to your work
- Tools and supplies used in your work
- Travel, transportation, entertainment and gift expenses related to your work
- Union dues and expenses
- Work clothes and uniforms, if required and not suitable for everyday use

Business Bad Debt

A business bad debt is a loss from a debt created or acquired in your trade or business. Any other worthless debt is a business bad debt only if there is a very close relationship between the debt and your trade or business when the debt becomes worthless. A debt has a very close relationship to your trade or business if your main motive for incurring the debt is a business reason.

Retirement Plans

For you to qualify as a participant in a tax-deductible retirement plan funded by your business, you must have earned income each tax year in which you wish to participate. Earned income consists of your share of the business' profits plus W-2 wages paid to you by your business. Earned income does not include S corporation profits. Dollars used to fund your retirement plan are tax-deductible to your business and grow tax-free until you retire.

Retirement plan rules are complicated and penalties for violating these rules can be severe. Using your local credit union, insurance agent, or bank for retirement programs may be adequate for some businesses and a mistake for others. You should secure competent advisors for your retirement plans.

AVOIDING AN AUDIT

Background

There are several reasons why small businesses should prepare for the possibility of an IRS audit. An audit takes valuable time from your business and costs you to hire audit representation. Facing an audit without representation is like representing yourself in court. With the IRS experiencing significant personnel turnover, and in the midst of hiring new auditors, you have a good chance of facing a less-experienced auditor. This means your audit may take longer and you may need to address audit issues that an experienced auditor knows are irrelevant. An audit may take months to complete. As a small business owner, you should be prepared for an auditor visit to your place of business even if you have audit representation. Taking the necessary precautions will help alleviate some of the headaches associated with an audit. As Benjamin Franklin once said, "An ounce of prevention is worth a pound of cure."

How Taxpayers Are Selected

Some audits are triggered by a whistle-blower and some are simply random. However, most audits are scheduled because of very high or very low Discriminate Inventory Function (DIF) System scores. This is a number assigned to your return after it is processed. Your DIF score is based on comparing tax returns to other businesses in the same standard industrial code. The more your DIF score is higher or lower than the average, the more you are likely to be the target of an audit. If your DIF scores are average, then you are less likely to be audited.

Things to Consider When Preparing Your Tax Return

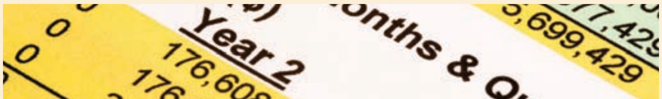
You may take certain steps to avoid being a target. Your tax return entries should be accurate and hopefully result in your return having an average DIF number. Your return should reflect that you have taken time to keep good records. Having only a few entries on your return implies you have taken shortcuts. Also, you may want to try to avoid lumping a multitude of costs into the office category rather than listing them as a capital asset.

Consider the following important questions when preparing your tax return.

- Is your cost of goods figure in line with your industry?
- Are vehicles and vehicle expenses appropriate for your business?
- Is compensation realistic, or is it too low or too high?
- Are there expenses for employee health insurance but no payroll?
- If you are an S Corporation shareholder unreasonably low compensation can trigger an audit.

- Should the independent contractors really be W-2 employees?
- If you receive large amounts of cash, have you complied with the IRS Form 8300 reporting rules?
- Are you filing your federal and state tax reports on time? Failure to report or pay on time draws unwanted attention to your business.
- Is your lifestyle (perhaps matched to others in your ZIP code) consistent with your income?

The IRS has been limited in doing financial status audits, but still may do so if they have reasonable indication there is a likelihood of unreported income. Auditors can examine credit reports, property tax records, business license applications, credit applications, motor vehicle records, currency transaction reports, and other documents to get a sense of your income.



Audit Hot Buttons

These are some IRS audit issues for business filers:

- Reflecting the proper amount of personal auto use
- Claiming a business that is really a hobby
- Claiming personal deductions on business returns
- Claiming spouse travel expenses
- Deducting start-up expenses instead of following amortization rules
- Unreported income
- Proper use of cash versus accrual method of accounting
- Taxpayer not being involved in the business on a regular and continuous basis
- Failing to follow capital asset depreciation rules
- Designating workers as independent contractors when they should be employees
- Claiming family members as employees who may not really be employees
- Improper retirement program funding
- Giving employee fringe benefits when there are no employees or giving employee fringe benefits to an independent contractor
- Lack of adequate record keeping for listed property (autos, phones, certain computers or entertainment facilities)
- Accumulated earnings
- Losses taken but not allowed because of basis limitations
- Losses taken but not allowed because of insufficient business involvement
- Loan applications where the taxpayer states income or assets not consistent with the tax return

12 Ways to Help You Avoid An Audit

(1) **GROSS RECEIPTS SHOULD AGREE WITH BANK DEPOSITS:** The first area an auditor will test is how your bank deposits compare with your gross receipts. If they do not match up, three issues arise. First, the auditor will assume you simply made a mistake and will gross up your receipts to match the bank deposits. Second, it sets the tone for the remainder of the audit. If the gross income is wrong, what else is wrong? Third, it may give the IRS a reasonable indication there is a likelihood of unreported income and trigger a financial status audit. The auditor may require you to produce the years' bank statements for all accounts. This is a solid reason to use a business checking account and to not use your personal checking account for business.

(2) **DO NOT USE ROUND NUMBERS FOR DEDUCTIONS:** You want to prove that you are keeping precise and accurate records. If you use round numbers, the IRS will think you are estimating your expenses and this will raise a red flag.

(3) **KEEP ORIGINAL RECEIPTS OF EXPENSES:** For large deductions, such as medical bills or charitable donations, it is best to attach copies of receipts, checks, insurance reports and anything else you have to prove their legitimacy. Keep the original documents in your files. If your tax return is tagged for additional scrutiny, having the documentation attached to your return and readily available in your files could eliminate the need for a larger audit.

(4) **KEEP TAX RECORDS AND CORRESPONDING DOCUMENTS FOR AT LEAST SEVEN YEARS:** The IRS has up to three years to audit your filed return. Therefore, it is important to keep your tax records for at least that long. Additionally, the IRS has six years to come after you if they believe you under-reported your gross income by more than 25 percent on a filed return. This is why it is essential to keep your records organized for at least seven years, so that they are easily accessible if necessary. These limits apply only if a return is filed. If a return has never been filed, these time limits do not apply because the statute of limitations does not start running until you file a return. In other words, you are forever open to a tax assessment or audit if you have never filed a return for a particular tax year.

(5) AVOID HANDWRITING YOUR RETURN: Do your return by computer or typewriter. The IRS tends to give handwritten returns closer scrutiny. A sloppy return may invite an audit because the examiner has difficulty reading the return.

(6) LIMIT ITEMIZED DEDUCTIONS: You are expected to claim every deduction to which you are entitled by law. However, it is a good idea to avoid large amounts of itemized deductions relative to income. Claiming large deductions that exceed your income can put you at risk for an audit. Keeping good records will assist you in the event of an audit. Attaching a note explaining unusual situations may also help to avoid an audit.

(7) REPORT ALL TAXABLE INCOME: Do not forget to report cash prizes, bartering, cash payments, alimony, tips, 1099-MISC income, 1099-R, W-2G gambling, capital gains and anything else that is considered taxable income. IRS computers are getting better at matching what is on your return with what others say they paid you.

(8) CHECK YOUR MATH: The IRS automatically corrects some mathematical errors, but that does not mean a return full of math errors will not be red-flagged. If you are filing paper returns, check your math carefully to avoid careless errors that could cost you later.

(9) KEEP A WRITTEN DIARY OF EXPENSES: Even though you may have a receipt to document a business expense, it is a good idea to keep a diary notation (or expense report) as a supplement to your receipt. This can help in establishing business travel and entertainment deductions.

For example: Documentation for a business meal should include the following information:

- The amount paid
- The name and location of the restaurant
- The person you entertained
- The person's business relationship with you
- The business discussion related to the entertainment

(10) KNOW WHEN TO FILE: Have your return prepared early. If you have a big refund and are unconcerned with audit issues, file early and get your money back. If you have taxes due, and no penalty for underpayment, avoid filing too early. Tax payments made prior to April 15th for the previous year's tax liability are interest-free loans to the IRS.

(11) AVOID OFFSHORE ACCOUNTS OR CREDIT CARDS: Many people put money in an offshore account to avoid paying taxes on the interest. The IRS has begun to scrutinize taxpayers with offshore accounts.

(12) BE CAREFUL WHEN TAKING A HOME OFFICE DEDUCTION: Be sure to consult with a tax professional to determine whether your home office qualifies for the deduction and the appropriate deduction amount. Have pictures showing your home office. Having personal items in the picture is a good way to defeat your claim that it is solely used for business. This is an item that the auditor may be checking when they visit your business in person.

What to Do if You Are Selected for an Audit

(1) OBTAIN AUDIT REPRESENTATION: Taxpayers are permitted to have audit representation in an audit. Certainly some taxpayers could represent themselves adequately, but they are the exception rather than the rule. You should obtain representation prior to contacting the IRS.

(2) OBTAIN ADVICE AND REPRESENTATION ONLY FROM LEGITIMATE AND REPUTABLE SOURCES: Look for credentials such as an Enrolled Agent, a CPA, or a tax attorney who is qualified to practice before the IRS. In addition, consider knowledge and experience. A good professional will provide references.

(3) DON'T PANIC! Remember that your proper record-keeping practices will help alleviate the burdens of an audit.

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UNDERSTANDING THE INDIVIDUAL AMT

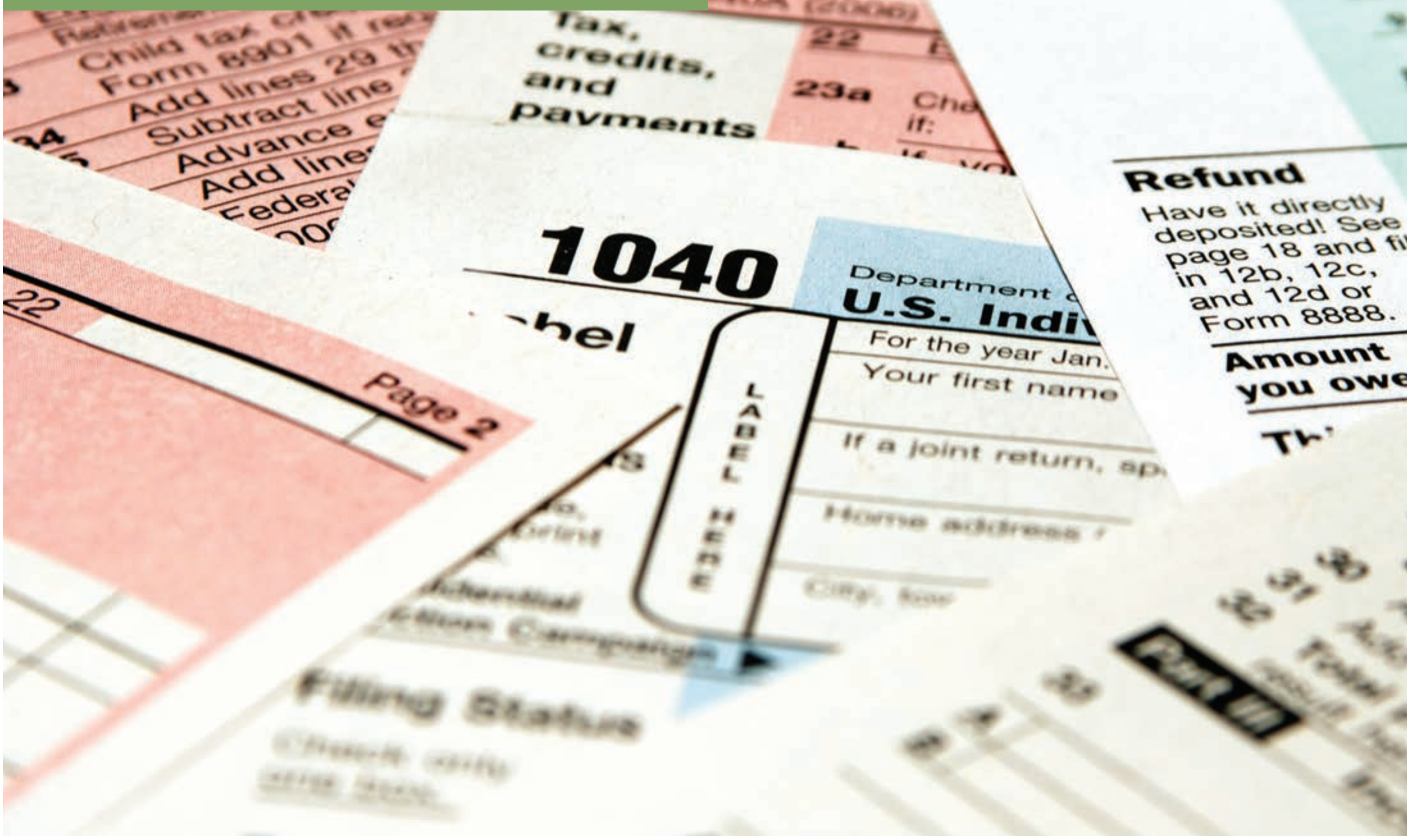
Background

The Alternative Minimum Tax, commonly referred to as AMT, is one of the most complex federal taxes in existence. It was designed almost 40 years ago to prevent only the wealthiest taxpayers from avoiding paying taxes altogether. Under the AMT, taxpayers effectively calculate their taxes under two systems (regular income tax and AMT) and pay the higher of the two liabilities.

Unfortunately, in recent years, more and more middle-income taxpayers have been subject to the AMT and have consequently owed additional taxes because the AMT exemption is not indexed for inflation.

Improved, But Still A Problem

The AMT was permanently "patched" in 2013 as part of the fiscal cliff deal. While this provides significant relief for many business owners, the AMT still hits a large number of businesses and NFIB continues to advocate for its repeal.



Calculating the AMT Step-by-Step Instructions

Every year, taxpayers need to consider whether they will have to pay the AMT. The AMT has evolved into a tax system that is parallel to our regular income tax system. It expands the amount of your income that can be taxed, adding back items that were tax-free (exempt) under the regular tax system and disallowing many deductions and credits. The following steps show how the AMT is calculated.

STEP ONE: Add back various tax preference items to your taxable income (see page 5 for the disallowed deductions). This new amount then becomes your **AMT tax base.**

STEP TWO: The appropriate AMT exemption is subtracted from the AMT tax base, calculated in Step One. The AMT exemption amounts for 2014 are: $82,100 for married individuals filing jointly, $52,800 for single filers, and $41,050 for married individuals filing separately. These exemption amounts were permanently in the American Taxpayer Relief Act of 2012.

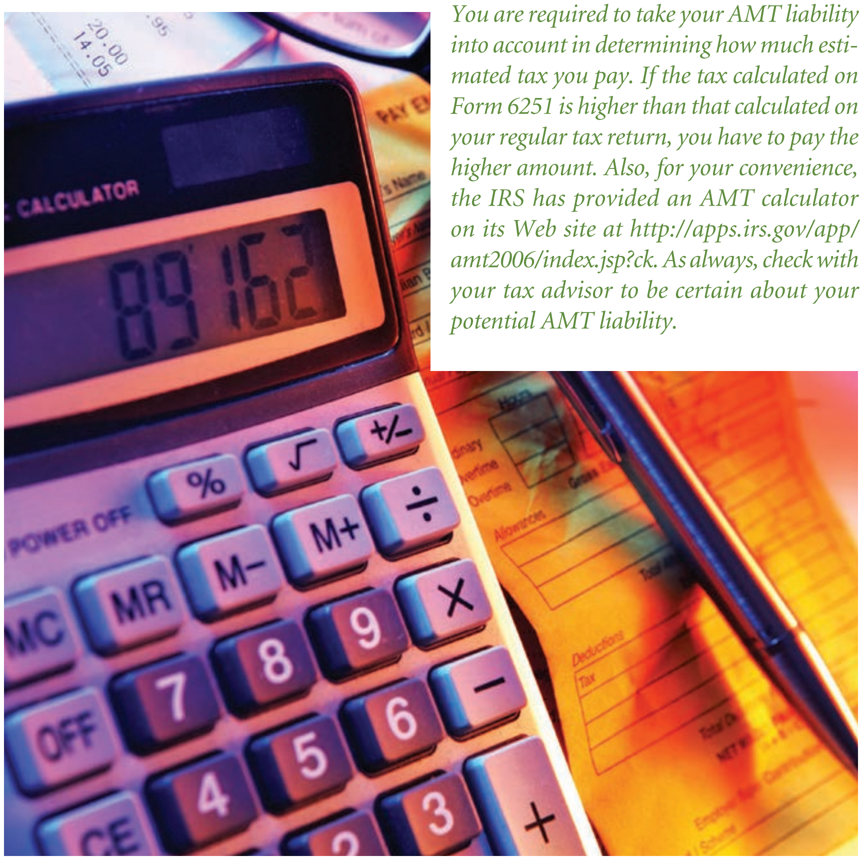
The basic AMT exemption amount begins to phase out at a rate of 25 cents for each dollar of AMT taxable income that exceeds certain threshold amounts. These thresholds are: $156,500 for joint returns, $117,300 for unmarried taxpayers, and $78,250 for married taxpayers filing separately.

STEP THREE: After calculating Step Two, if your AMT tax base is less than the exemption amount, you are not subject to the AMT. If you still have an AMT tax base remaining, a two-tiered tax rate structure of 26 percent and 28 percent is then assessed against the remaining AMT tax base to determine AMT tax liability. [*By comparison, the regular income tax rate schedule starts at 10 percent and then moves through a series of steps to a high of 35 percent.*]

The AMT tax rate schedule is 26 percent of the first $182,500 ($91,250 for married filing separately) of AMT taxable income in excess of any AMT exemption and 28 percent on any additional AMT taxable income.

If the calculated AMT tax liability is higher than your regular income tax liability, you will pay the AMT tax liability and move on to Step Four.

NOTE: Capital gains and dividend income are still taxed at their normal rate and not at the AMT rates. Today, the capital gains and dividend rate is 15 percent.



STEP FOUR: The AMT liability can be reduced by the full amount of an individual's personal tax credits. Some of these personal tax credits include:

- Dependent care credit
- Credit for the elderly and disabled
- The HOPE Scholarship credit
- The Lifetime Learning credit
- Adoption tax credit
- Child tax credit
- IRA tax credit
- Credit for electricity

STEP FIVE: For future tax years you may be eligible for an AMT tax credit that is calculated as an item to be carried forward to offset regular income tax liabilities. To calculate and report your AMT tax credit, you need to fill out Form 8801, Credit for Prior Year Minimum Tax.

NOTE: To calculate and report your AMT liability you need to fill out Form 6251, Alternative Minimum Tax — Individuals. You are required to take your AMT liability into account in determining how much estimated tax you pay. If the tax calculated on Form 6251 is higher than that calculated on your regular tax return, you have to pay the higher amount. Also, for your convenience, the IRS has provided an AMT calculator on its Web site at http://apps.irs.gov/app/amt2006/index.jsp?ck. As always, check with your tax advisor to be certain about your potential AMT liability.

Deductions *Not* Allowed Under AMT

(1) THE STANDARD DEDUCTION

(2) MEDICAL EXPENSES: If you itemize deductions, medical deductions are only allowed to the extent that they exceed 10 percent of adjusted gross income, rather than 7.5 percent under the regular tax system.

(3) CERTAIN ITEMIZED DEDUCTIONS: You cannot take itemized deductions for state and local income tax, real estate taxes, general sales taxes and personal property taxes, even though these were deductible on your regular return.

(4) MISCELLANEOUS 2 PERCENT ITEMIZED DEDUCTIONS: Tools, legal, tax preparation, dues, business publications and employee business expenses.

(5) DEPRECIATION DEDUCTIONS: These are added back to the extent the deductions taken under accelerated provisions exceed the slower depreciation rules. For property placed in service after 1998, if the 200 percent declining balance method is used for regular tax purposes for 3-, 5-, 7-, or 10-year property, then the 150 percent declining balance method and regular tax depreciation period must be used for AMT purposes.

For all other property placed in service after 1998, no AMT adjustment is required, as AMT and regular tax depreciation are the same. For property placed in service after 1986 and before 1999, similar adjustments must be made.

Adjusting MACRS depreciation deductions (see pg. 8), rather than treating them as Tax Preference Items, may provide taxpayers with some major benefits as they compute AMT in the later years of a property's use.

Generally, no AMT adjustments have to be made to the amount expensed under IRS Code Section 179.

NOTE: When disposing of depreciated assets, the depreciation rules differ between regular and AMT; you are likely to have a different gain or loss amount to report.

(6) TAX-EXEMPT INTEREST: Taxpayers will have to add back tax-exempt interest, less any related expenses, on specified private activity bonds, which generally are issued after August 7, 1986.

Certain Home Mortgage Interest Payments May Be Allowed as a Deduction

Among the interest deductions that may be claimed against AMT taxable income is qualified housing interest. This is similar to the qualified residence interest deduction that may be claimed against regular tax. Qualified housing interest is interest paid on a loan used to purchase, build or improve a taxpayer's principal residence or other dwelling (i.e., a house, apartment, condominium or mobile home that is not used on a transient basis). Interest on a refinanced loan is also deductible if the loan does not exceed the balance remaining on the original loan. This eliminates many home equity loans and loans on motor homes, boats, etc., because these dwellings are not qualified dwellings for AMT purposes.

You May Get Hit With AMT Liability If You Have

- High state and local taxes, including income, property, personal property and sales taxes.
- A large family.
- A large amount of deductible medical expenses.
- Exercised incentive stock options.
- A large number of personal exemptions.
- A large amount of miscellaneous itemized deductions.
- A large amount of capital gains.

Investors in a tax shelter should be aware that they may have a higher probability of being subject to this tax. Investors in a tax shelter have increased risk of facing the AMT because most tax shelters are structured to maximize the use of tax preference items.

NOTE: If you have any of these issues on your tax return, or any combination of them, you should consult with your tax advisor to determine whether you have any AMT liability.

Minimizing Your Exposure

ACCELERATE INCOME

- Take a prepayment of salary or bonuses.
- Recognize short-term gains on portfolio securities.
- Redeem Series EE U.S. Savings Bonds or certificates of deposit.
- Withdraw money from your IRA or other retirement funds.
- Convert tax-free bonds to higher yielding taxable bonds.

DEFERRING DISALLOWED AMT DEDUCTIONS

- Defer making your estimated state income-tax payments until the next year.
- Defer paying your real estate or personal property taxes until the next year.
- Defer any medical expenses if the total doesn't exceed 10 percent of your adjusted gross income.
- Defer payment of any employee business expenses, union dues, job-education, investment and tax-preparation expenses.
- Spread the exercise of any incentive stock options over a multi-year period to minimize the amount of preference items in any single year.
- Depreciate rather than deduct business furniture and equipment.