

IRS Targeting Small Businesses



By Dan Caplinger

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As anyone who has done it will tell you, running a small business is difficult. Not only do you have to be able to do well, but you also have to deal with all the formalities and paperwork involved in owning and operating a business. Between licensing and permit requirements, taxes from several levels of government, and dealing with suppliers and employees, it's sometimes amazing that business owners ever get any client work done at all. Yet small businesses commonly seen as the backbone of the American economy, providing a significant fraction of jobs for the labor force.

However, small businesses now face a threat of increased scrutiny from the IRS. In a recent news conference, IRS Commissioner Mark Everson indicated that the IRS will start focusing their audit activities on small businesses, especially unincorporated businesses. Despite tax settlements involving big companies, such as Eastman Kodak's (NYSE: E) big tax refund last year and ServiceMaster's (NYSE: SVM - News) \$131 million agreement with the IRS, Everson cited the largest cause for shortfalls in tax collections is in individual taxpayers, especially sole proprietors, failing to report income. While wage earners have their income amounts verified by their employers, there is sometimes no independent reporting of income that small businesses receive; what the taxpayers put on their Schedule C attachments to their tax returns is the only information the IRS gets about the income and expenses of the business.

Why it's a big deal

One likely reason why the IRS wants to crack down on unincorporated businesses is because there are substantial potential lost revenue involved. Employees who receive regular wage income have payroll taxes withheld from their paychecks and then pay income tax through periodic withholding and on their annual tax return. Owners of unincorporated businesses, on the other hand, pay both income tax and payroll taxes in the form of self-employment tax. What this means is that unincorporated business owners choose not to report income, they not only reduce their income tax at rates up to 37% but also eliminate revenue subject to self-employment tax rates that cost as much as an additional 15.3%.

In addition, when evaluating the expenses of a small business, it can be challenging to separate what the owner uses for business purposes from personal items. While larger businesses usually have dedicated real estate, supplies, and vehicles that are clearly used solely for business purposes, small businesses often lack the resources to maintain clearly defined boundaries between business and personal use. As a result, there's a greater danger that small business owners will claim business deductions for expenses that are more personal in nature.

Is the IRS overreacting?

On the other hand, there are a number of factors that probably produce greater amounts of tax for the IRS than they should impose. Confusing rules about legitimate business expenses, including the deduction for home office expenses, lead taxpayers simply to forego claiming tax deductions for fear that their returns will be audited. While some businesses certainly overreach in the expenses they choose to deduct, others are overly cautious to claim only those expenses which they feel most comfortable, even when it results in paying more tax than they should. Doing what they can to avoid spending the time and money necessary to respond to an IRS audit makes paying a bit of additional tax a small price to pay.

Moreover, many small businesses have income that is independently verified by third parties. For those businesses that perform a substantial amount of work for other businesses, much of their income will be reported by their business customers on Form 1099-MISC, which is required for payments for services in excess of \$600 annually. Given the increasing trend of companies to treat workers as independent contractors rather than employees, many workers that are treated as independent contractors have little or no ability to understate their income.

On the expense side, many small business owners likely are offended by the notion that they are overstating their expenses.

Many employees of large businesses have expense accounts that give them considerable latitude to spend company money on things that are only loosely connected to business activity; the largesse of traveling employees with expense accounts is a well-documented part of the corporate culture. Small businesses, on the other hand, often can't afford to use their limited resources on such lavish expenditures, instead saving them for the necessary expenses of running their business. Scrutinizing small business expenses while giving large corporations carte blanche to deduct similar expenditures is a small business owner's nightmare and runs counter to the idea that the government should encourage entrepreneurs to create small businesses.

Most people would agree that everyone deserves to pay their fair share of income taxes and that those individuals and companies that flagrantly violate tax laws should be punished severely. However, small business owners, who are overburdened by demanding administrative requirements, economic challenges, and the day-to-day tasks of actual business, are perhaps the least capable of taking in stride the difficult work of facing an IRS audit. As the economy shows possible signs of sinking into recession, increasing audit activity may prove to be the death knell for small businesses that are already on the brink of collapse.

Fool contributor Dan Caplinger and his small business face the same concerns that thousands of other entrepreneurs do. He doesn't own shares of the companies mentioned in this article. The Fool's disclosure policy doesn't distinguish

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