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Best Tax Practices for Small Businesses

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The Internal Revenue Service has sent letters to thousands of small business owners recently, questioning whether they underpaid their taxes last year.

Titled “Notification of Possible Income Underreporting,” the letters were mailed to small employers this summer requesting that they review and confirm that they accurately reported their income on their 2012 tax returns.

In response to this action by the IRS, American University professors Donald Williamson and David Kautter have created a list of “Tax Best Practices for Small Businesses,” a checklist designed to help small business entrepreneurs stay up-to-date on all tax related issues, and away from the scrutiny of the IRS.

1. Keep good records about who is an "employee" and who is an "independent contractor."

2. Keep track of places where you may have a "physical presence" (even unknowingly), to properly comply with state rules governing sales tax collection.

3. Invest in good tax software accounting systems—those that track your records and regularly provide updates to new IRS rules.

4. Hire a tax accountant who has experience in your type of business, whether it's a coffee shop or a construction business.

5. Keep good records on how much you paid for, and the date you placed in service, all business equipment, business vehicles, etc.

6. Don't consider using funds you have withheld for employee payroll taxes (or any taxes, for that matter) as a short-term loan to tide you over during a shortfall in working capital.

7. One of the biggest traps for small business taxpayers is estimated taxes—paying them on time, calculating them correctly, and knowing the safe harbors that can protect you against underpayments. Miscalculating any of these steps can be a major headache, so speak with someone, most likely a tax accountant or enrolled agent, who knows the rules cold.

8. If your spouse, child, mother-in-law, or other close relative works in your business, make sure he or she abides by the same employment rules as your unrelated employees.

9. Select a "tax year" for your business that reflects the natural ebb and flow of your business's receipts and disbursements. This way, you won’t get caught in a cash crunch when tax time comes.

10. You or your accountant should retain all relevant tax records for at least three years, and if your records relate to property and depreciation, keep them until the property is disposed of, plus an additional three years.

11. Keep detailed records on how you use your personal or business-owned vehicle for business vs. personal purposes.

12. Hire a reputable third-party administrator (such as Fidelity or Vanguard) to manage your 401(k) plan and other tax-favored employee benefits.

13. Make sure that you and your tax accountant are familiar with the tax rules, including the favorable tax credits and deductions that are unique to your business.

14. If it becomes necessary for your small business to open a foreign bank account in order to pay vendors or others in another country, make sure you and your tax accountant are vigilant in following the new rules on foreign bank accounts, known by the acronym FATCA (short for Foreign Account Tax Compliance Act).

15. If your hope is that your business will continue after you die, under the leadership of another family member or designated heir, take steps to protect the business against a forced sale in order to pay inheritance taxes.

16. Don't become foolishly emboldened by thinking that the IRS will have to “prove” that you have done something that doesn’t comport with the tax law. The burden of proof is always on you, not the IRS.

17. Become familiar with the tax rules surrounding starting, running, selling and shutting down a business. Determine whether you should operate as a partnership, an S corporation, an LLC, or a sole proprietorship. Your tax accountant should be closely familiar with these rules.

18. Have a one-on-one conversation with your accountant about the Affordable Care Act.

19. If you can't pay the taxes you owe to the IRS, or another tax agency, contact your accountant right away. This situation won’t get better by ignoring it.

20. When someone pays you in cash, it doesn’t mean that payment is nontaxable. The IRS has state-of-the-art statistical technology and models based on spending habits and bank accounts to build a case against alleged tax cheats.

Donald Williamson is a CPA, attorney and professor who has served as director of the Master of Science in Taxation degree program at ***American University’s Kogod School of Business*** *for more than 25 years. Previously, Williamson was senior manager for international taxation at the National Tax Practice Office of KPMG in Washington, D.C., and professor-in-residence at KPMG’s Washington office. David Kautter is a CPA and attorney, and serves as executive-in-residence in the department of accounting and taxation at American University’s Kogod School of Business. He joined Kogod following a distinguished career as a partner at Ernst & Young LLP, where he held key technical and leadership roles spanning more than three decades. Kautter served as Ernst & Young’s*

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