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HOW IRS AUDITS CONSULTANTS

By Victor Sy, CPA

The IRS has issued a guide on [how to audit consultants](#). IRS agents are told to be **alert to the following issues**:

- Travel and meals,
- Bartering,
- Independent contractor 1099 versus employee W2,
- Shifting or assignment of income by a taxpayer to a related entity,
- Personal service corporation, and
- Internal controls, books and records, electronic software, and use of the Internet.

Travel. The nature of consulting business requires extensive travel inside and outside the U.S. Many consultants have a specialized niche and a wide geographical client base. Auditors are told to look for spousal/family travel and personal travel, particularly out of country.

Meals and entertainment. Given the considerable travel usually required in the consulting industry, auditors are alerted that there may be sizeable expenses for meals and entertainment. Check deductions for personal meals and entertainment.

Bartering: Auditors are told to verify client subsidiary ledger cards that may lead to exchange of consulting services for other services that do not hit the books. For example, a consultant may borrow a large sum of money from a corporate client and then pay it off by performing legal services. The income from legal services is not declared and no income tax is paid on it.

Independent contractor vs. employee. IRS has observed that the independent contractor versus employee issue is prevalent in the consulting industry. Potential areas of concern include a former employee coming back to a company as an independent consultant with a minimal break in service. This issue has evolved due to the downsizing taking place in the business world over the past decade. Many employers, in an effort to lower costs, have terminated specialized employees and then hired them back as independent consultants. This allows the employer to lower their costs in payroll and employee benefits.

Shifting or the assignment of income/substance versus form. Auditors are informed that closely held or one-person personal services corporations may have shifted income from themselves to another entity in order to reduce their income and self-employment taxes. The taxpayer may shift income earned by one entity to a related entity in order to offset net operating losses of a related entity. Subsequent to this shifting of income, the taxpayer may take a relatively small salary from the entity that received the assigned income in relationship to the amount of income shifted. Examiners are told to review the taxpayer's consulting agreements/contracts and to look for certain information. For example, auditors should look at whether the taxpayer is an S corporation or a partnership and yet the contract requires the services of a particular employee/owner.

Personal service corporations. Consultants doing business as regular C corporations are at tax disadvantage because they are classified as personal service corporations (PSC) and must use a higher rate. Check if the entity is using low tax brackets that start at 15% and 25% instead of the high flat rate of 35% that applies to PSCs. **TIP:** Elect S status to get out of this unfortunate tax situation. Not only do you avoid the high 35% rate, you also elect to pay zero federal income tax. You also get a bonus in California: a very low rate of 1 ½ % instead of the regular rate of about 9% for C corporations. Read our tax tips on S corporations at www.victorsycpa.com.