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Small Business in IRS Sights

By JOHN D. MCKINNON and SIOBHAN HUGHES

Thousands of small-business owners have received letters from the Internal Revenue Service questioning whether they are underreporting their business income, a harbinger of a broader initiative aimed at boosting federal tax receipts and ensuring compliance.

The program is the latest move in the agency's effort to combat what it sees as a widespread problem: failure by businesses, including mom-and-pops, to report all cash sales in order to minimize tax bills.

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Tax officials say the letters don't constitute an audit and instead are simply a request for more information. Some business owners and some lawmakers, however, call the new IRS program alarming.

"There's an emotional thing when you get a pretty ominous-looking letter from the IRS, [saying] you might have done some bad things," said Tom Reese, owner of Hearing Well Inc., which operates a small chain of stores that fit and sell hearing aids in eastern Tennessee, who received a letter in recent weeks. "I really work hard with my accountant to make sure that I not only follow the law, but follow the letter of the law."

The IRS says it is sending out about 20,000 letters to business owners as the program cranks up. While that is a small portion of the total number of U.S. small businesses, which is estimated in the millions, some tax accountants say they expect the program to expand.

Roger Harris, president of Padgett Business Services, a nationwide accounting firm that specializes in small businesses, said the letters have "created some heartache in the small business community."

The IRS program stems from a 2008 change in the law that gave the agency broader access to merchants' credit- and debit-card transaction records. The IRS has been comparing the data to information that small businesses report on their tax returns. If the data suggest an unusually large percentage of a business's receipts come from card transactions, the IRS might send a letter asking the business owner to explain why cash receipts seem relatively low.

Underreporting of income comprises the majority of the so-called "tax gap," the difference between what Americans owe and pay, according to IRS data. In 2006, the most recent year available, the total tax gap was $450 billion. Underreporting accounted for $376 billion of that total, and underreported small-business income totaled at least $141 billion.

One typical letter to a small-business owner is headlined, "Notification of Possible Income Underreporting." It begins, "Your gross receipts may be underreported."

The letter instructs the owner to complete a form "to explain why the portion of your gross receipts from non-card payments appears unusually low." It says the business owner must respond within 30 days.

"The letter implies that this is a serious matter that could lead to assessments of additional tax, penalties and interest," says a letter sent to the IRS Friday by Rep. Sam Graves (R., Mo.), chairman of the House Small Business Committee. The IRS is now the target of a series of congressional investigations into its giving extra scrutiny to conservative groups seeking tax-exempt status.

Fran Coet, who runs an accounting business in Westminster, Colo., says the new IRS practice will cause a lot of fear among small businesses because it can often be difficult to match credit transactions with income.

"There are so many reasons why, even if you're the most honest tax payer, you're not going to match" what card records show, says Ms. Coet, whose company advises about 250 small businesses. Ms. Coet cited sales of gift cards, which for accounting purposes don't count as a sale, but look that way to a credit-card company.

There are legitimate reasons why a business might report relatively high proportions of card receipts versus cash receipts. Card receipt totals can include cash that the customer takes back. Mr. Reese said his hearing aids carry price tags of $1,000 or more, which encourages clients to use cards.

Peter Fleming, a small-business accountant in Carnegie, Pa., said a client with a gift and souvenir shop received a letter from the IRS in December saying the revenue she claimed in tax returns the previous year was lower than sales reported in merchant card and third-party payments data. The retailer reported gross receipts of $243,462, versus $249,994 in the payment data, according to the IRS. The letter told her to ensure she was "fully reporting receipts from all sources" and gave her 30 days to respond. Mr. Fleming said the discrepancy was because payments data included sales tax, which wasn't included in revenue claimed in tax returns. For small retailers, "Sales tax is a liability and is not reported as revenue," Mr. Fleming said.

The IRS in a statement said the agency is "taking its first early steps" in using the new data, and promised "to carefully review the results of these initial steps." It said the agency is "working diligently to minimize burden on both taxpayers and tax professionals."

The agency defended its approach as "measured and equitable in several ways, including giving taxpayers the opportunity to explain and fix errors." It added: "An important component of this project is [to] help ensure that people who are non-compliant don't get an unfair advantage over those that play by the rules and follow the law."

The IRS has told accountants that a principal aim of its program is to verify the quality of the card-transaction data the agency is getting.

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