

# IRS Audits of Cash Businesses

Eric L. Green, Esq.

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## Eric Green, Esq.

- ▶ Managing partner in Green & Sklarz LLC, a boutique tax firm with offices in Connecticut and New York.
- ▶ Focus is civil and criminal taxpayer representation before the Department of Justice Tax Division, Internal Revenue Service and state Departments of Revenue Services.
- ▶ Eric is a contributing columnist for Bloomberg Tax and has served as a columnist for CCH's Journal of Practice & Procedure.
- ▶ Attorney Green is the past Chair of the Executive Committee of the Connecticut Bar Association's Tax Section.
- ▶ Eric is a Fellow of the American College of Tax Counsel ("ACTC").



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## Eric Green, Esq.



- Eric is the host of the weekly Tax Rep Network Podcast
- Eric is the founder of Tax Rep Network, an online community designed to help tax professionals build their IRS Representation Practice
- He is the author of the Accountant's Guides in IRS Representation
- Partnered with UConn and creator of the IRS Representation Certificate Program
- Creator of the Tax Rep App



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## Upcoming Events

- ▶ **Live From Miami:** Payroll Tax Train Wreck: The Story of Mary Jones (9/19)
- ▶ 10<sup>th</sup> Annual New England IRS Rep Conference (11/17 & 11/18)
- ▶ 2<sup>nd</sup> Annual Tax Rep Summit (12/12 – 12/14)
- ▶ Got to EVENTS menu at <https://TaxRepLLC.com>



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## Preparer Considerations

- ▶ We are not required to examine our own clients
- ▶ In general we may rely in good faith upon client provided information
- ▶ We CANNOT ignore the implications of information provided that we either know or have reason to know is inaccurate, incomplete, inconsistent, or suspect is untrue
- ▶ We are required to disclose questionable positions taken on the return — Revenue Procedure 2014-15

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## Requirement to Make Reasonable Inquiry

- ▶ The return preparer is required to make reasonable inquiries if the information furnished by the taxpayer is either questionable or appears to be inconsistent or incomplete
- ▶ Some deductions or credits require us to confirm that certain information be available before they can be claimed

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## What about the QuickBooks File?

- ▶ IRS will seek a back-up of the QuickBooks file
- ▶ IRC Section 6001
- ▶ Regulation 1.6001-1(a) and -1(e)
- ▶ Revenue Ruling 71-20
- ▶ Revenue Procedure 98-25



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## QuickBooks — Concerns?

- ▶ More years than the exam covers
- ▶ Adjusting entries that give rise to questionable practices
- ▶ Fishing expedition?



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## Preparing for the Audit

- Walk through
- Instructions to the taxpayer
  - a) Do not speak to the examiner
  - b) Do not Tweet, Facebook® or say anything else on social media about the exam!
  - c) Respond to all requests quickly



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## Hot Button Issue – Gross Receipts

- ▶ Federal return v. Sales tax returns
- ▶ Federal return v. Bank deposits
- ▶ Federal return v. Cash register/POS system
- ▶ Federal return v. 1099s reported



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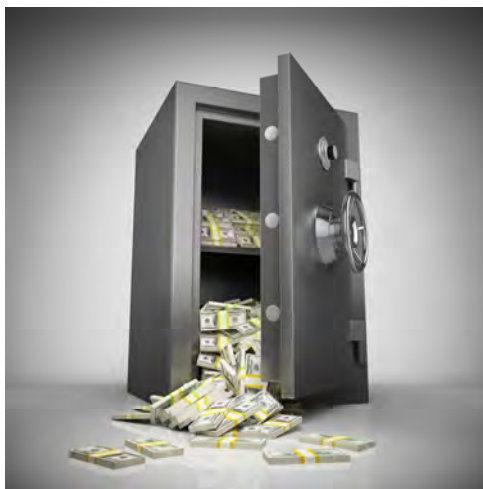
## Hot Button Issue — *Expenses*

- ▶ Expenses ordinary for this type of business
- ▶ Expenses are in line with industry statistics (the DIF)
- ▶ Expenses are supported by evidence of payment?
- ▶ W-2s or 1099s issued?
- ▶ Were the expenses paid/incurred during the tax year?



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## IRS Focus on Cash Businesses



- ▶ The GAO reports that much of the \$406 billion tax gap is driven by businesses who underreport their income, often due to cash transactions
- ▶ Focus is now on those individuals or businesses that deal in cash

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## IRS Focus on Cash Businesses



3 Ways to misappropriate cash from a business:

1. Skimming it from receipts
2. Cash or goods can be stolen and used later for resale
3. Fraudulent disbursements

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This is an old Zapper that's been hard wired into the ECR



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This is a newer Zapper – It's a removable device connected to the PC, not the ECR.



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## Indicators of Unreported Income

- ▶ Excessive lifestyle
- ▶ Business continues operating despite losses year after year
- ▶ Bank deposits or liquid investments continue to increase each year despite reporting of losses or low income
- ▶ No income reported yet debt decreases year after year
- ▶ Unusual margins or sales for the industry standard for this type of business



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## IRS Focus on Cash Businesses

- ▶ Examiners are to look for income
- ▶ Expenses are generally easier — either supported or not
- ▶ Indirect methods of income analysis may be employed
- ▶ Will look at the individual owner as well — will create a burden on the taxpayer individually

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## Cash Businesses Targeted



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## IRS Pre-Contact Planning

- ▶ When the IRS knows it will be targeting a cash business there will be some specific pre-contact review done
- ▶ The business owner's 1040 will be reviewed
  - a. Is the owner's home in a high-value area disproportionate to reported income?
  - b. Will reported income support family size?
  - c. Does he or she have the foreign accounts box checked?

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## IRS Pre-Contact Planning

Examiners are advised to review external sources, including:

- ▶ Bureau of Labor Statistics
- ▶ Social Security Administration
- ▶ PO Office Database
- ▶ Department of Motor Vehicles
- ▶ Social Media
- ▶ Google/Yahoo/etc.
- ▶ State Licensing Databases

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## Taxpayer Interview

- ▶ Auditors will request a TP interview
- ▶ Almost NEVER do this
- ▶ The Taxpayer is not required to be agree - IRC § 7521
- ▶ TP will (usually) not help their case

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## Taxpayer Interview

- ▶ If it is a cash business, Examiner will be insistent on the taxpayer interview
- ▶ Will focus on accounting for cash receipts
- ▶ “Is all revenue properly reflected on the return as filed?”
- ▶ Will request copies of all bank accounts and then ask: “Are all bank accounts present?”
- ▶ Will focus on cash used to pay expenses as well
- ▶ Auditor knows taxpayer will be more responsive now when no issues have been raised yet



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## Use of a Summons

- ▶ When the taxpayer does not have adequate books and records a summons will be used on third parties (i.e., banks)
- ▶ Copies of checks and deposits will also be summonsed
- ▶ Taxpayer may also be summonsed to answer questions if they are being uncooperative
- ▶ John Doe Summonses on check cashers, foreign banks and Coin Base

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## Use of Minimum Income Probe

- ▶ Called a "Cash-T Analysis"
- ▶ Examiner will review the expenditures
- ▶ Compare them to reported income
- ▶ Shortfall, if unexplained, is considered unreported income



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## Cash-T Analysis

T-Account	
CASH RECEIVED	CASH EXPENDED
Gross Receipts (per Return)	Business Expenses (less depr.)
Gross Rents	Rental Expenses (less depr.)
Wages/Miscellaneous Income	Personal Living Expenses
Interest/Dividend Income	Purchase of Assets
Cash on Hand (at beginning)	Cash on Hand (at year end)
Cash in Bank (at beginning)	Cash in Bank (at year end)
Loans Received	Loan Payments
Nontaxable Income	
Accounts Receivable (at beginning)	Accounts Receivable (at year end)
Accounts Payable (at year end)	Accounts Payable (at beginning)
Total Cash Received	Total Cash Expended

Therefore: Total Cash Expended less Total Cash Received = Unidentified Income.

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## Bank Deposits as Unreported Income

- ▶ Bank deposits are prima facia evidence of unreported income — ***Tokarski v. Commissioner***
- ▶ Burden to show the IRS determination is wrong lies with the taxpayer — ***Estate of Mason v. Commissioner***
- ▶ IRS is required to consider non-taxable sources of income or non-deductible expenses — ***DiLeo v. Commissioner***
- ▶ IRS is required to follow all leads reasonably susceptible of being followed that income is from non-taxable sources — ***Holland v. United States***

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## Net Worth Analysis

- ▶ Assets – Liabilities = Net Worth
- ▶ Obtain a good starting net worth
- ▶ Assets at cost
- ▶ All expenses are factored in — deductible and non-deductible
- ▶ Can increases be explained by known income
- ▶ If not, assumed to be unreported income



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## Focus on Industries

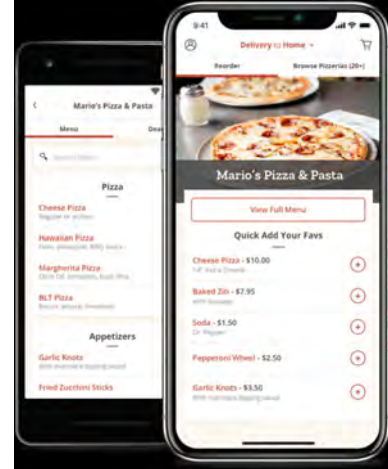
Examiner will seek to compare other data to gross receipts

- ▶ Hair dresser's calendar x average price v. gross receipts
- ▶ Reported industry standard will be used to compare
- ▶ Pizza shops
  - Purchase of cardboard boxes – inventory on hand = pizzas sold
- ▶ Bail Bondsman
  - Bonds posted x 10% = receipts v. reported gross receipts
- ▶ Child care locations — seek industry standard of cash v. credit card purchases and compare to reported gross receipts

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## Remember: Industry Standards May No Longer Apply!

- ▶ Daycare Story
- ▶ Pizza Shop Story
- ▶ Apps are changing the game: Uber, Lyft, Slice, etc



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## Questions?

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