Lawmakers and the ever-vigilant Internal Revenue Service are aware that "fudging" on tax returns is becoming more and more popular. In fact, the Government Accountability Office (GAO), Congress' watchdog agency, estimates the individual income tax "gap," the difference between taxes owed and taxes actually paid, is in the hundreds of billions of dollars.

Be warned, however, the IRS is not only aware of the "fudging" possibilities, but they've developed a number of strategies for unearthing overlooked, ignored, or simply fraudulent cash transactions. In fact, the IRS recently released an Audit Technique Guide or ATG that not only provides guidance to its agents on how to examine income in so-called "cash intensive businesses"—a category that includes so many pressure cleaning businesses—it also reveals that the IRS is aware of the "underground economy" that so many businesses compete against—and often profit from.

Both individuals and businesses participating in the underground economy want to avoid government regulations and may not be licensed in their trades. For example, a woman may offer to cut and style hair in her home for $10 in cash, while a licensed stylist will charge $30 for the same haircut in a salon. Or, a tree trimmer will charge only $375 because the state requires licensing for jobs over $400. In this case, the hair stylist and the tree trimmer can get by with the smaller earnings because they do not carry the overhead costs or the tax responsibilities.

The underground business capitalizes on the "tax wedge" which is the difference between labor costs paid by an employer (gross wages) and the net wage received by an employee. An employer will pay wages of $50 per hour, which includes payments to FICA, FUTA, Medicare, retirement benefits, workers compensation insurance, etc., but the employee will net a wage of only $30 per hour. In the underground economy, the same worker will charge $30 per hour, cash, for the same work and the net result will be the same.

The recently-released ATG is neither a handbook on how to avoid taxes nor an official pronouncement of the law or the IRS's position. Rather, the ATG reveals just how much the IRS knows about cash intensive businesses, a category that includes many pressure cleaning operations, and the underground economy so many contractors, dealers, and businesses compete against.

CAUGHT! WHAT THE IRS KNOWS

by Mark E. Battersby

Ignoring Income

IRS auditors use the ATG to both find overlooked income and exaggerated deductions on tax returns that have been filed and how to find those within the underground economy who, in all likelihood, don't file tax returns or pay taxes.

The owners and operators of many pressure cleaning businesses often believe cash receipts can go unreported and escape detection by the IRS. After all, aren't cash transactions anonymous, leaving no trail to connect the purchaser to the seller?

Not too surprisingly, pressure cleaning business owners who fail to report all income send up an instant red flag in our computerized business world. Information mismatches produced by erroneous Form 1099 received by some pressure cleaning contractors often creates disparities in reported income.

Since few, pressure cleaning businesses currently receive Form 1099s, a significant indicator of underreported income that IRS examiners often direct their attention to is a consistent pattern of losses or low profits that seem insufficient to sustain the business or its owners. According to the IRS, other indicators of unreported income include:

- A lifestyle that can't be supported by the income reported
- A business continuing operations despite losses, year after year, with no apparent solution for correcting the situation
- Bank balances, debit card balances, and liquid investments increase annually despite reporting of low net profits or losses
- Accumulated assets increase even though the reported net profits are low or there is a loss
- Debt balances decrease, remain relatively low, or don't increase, but low profits or losses are reported
- A significant difference exists between the taxpayer's gross profit margin and that of his or her industry
- Unusually low sales for the type of business

Too Many Deductions, Too Little Income

The biggest problem for most pressure cleaning businesses—as well as their owners—is a lack of good expense records. The use of an automobile for business purposes is a classic example. Although the vehicle may have been used 75 percent of the time to call on customers, supervise work crews, or for other business-related purposes, many contractors and business owners fail to keep a detailed record and, thus, are unable to state that clearly on a tax return.

The IRS's auditors are also reminded that typical businesses of certain sizes generally have a "normal" range of expenses. Deductions that fall outside of this range or that appear unrealistic may trigger an IRS warning flag.

Between 2004 and 2008, the IRS conducted more than 5.1 million correspondence audits resulting in approximately $35 billion in additional taxes. Each return examined generated about $6,800 in recommended additional taxes, according to the Treasury Inspector General for Tax Administration (TIGTA).

Examiners are advised to try to match an expense item to verify the corresponding income is reported.

Digging Deeper

Every small business owner has claimed a personal expense as a business one. For little things, such as a few personal long-distance calls on a business telephone line, the IRS will often ignore the write-off. When $2,000 worth of repairs to a vacation home are claimed, however, the auditor might begin digging deeper.

Similarly, the IRS's audit guide notes that employment taxes should be a routine part of every audit of a small pressure cleaning business. Examiners are also required to consider the issue of employee versus independent contractor. Independent contractors or workers labeled as "independent contractors" are another red flag for an auditor.

Auditors are also reminded that all taxpayers are required by law to maintain accounting records of sufficient detail to enable the proper preparation of a tax return. If it is determined that the taxpayer has failed to maintain adequate records, then the issuance of an Inadequate Records Notice should be considered. This serves to place taxpayers on notice that their record keeping practices are deficient and must be improved to meet the requirements of the law.

Fraud is also an important consideration in any audit. Taxpayers who knowingly understate their tax liability often leave evidence in the form of identifying earmarks (or indicators). Fraud indicators include acts such as:

- Substantial unexplained increases in net worth
- Substantial excess of personal expenditures over available resources
- Bank deposits from unexplained sources substantially exceeding reported income
- Inadequate books and records conduct that is evasive, misleading, or uncooperative

Of course, a determination of fraud means there was deliberate deceit, subterfuge, camouflage, concealment, some attempt to color or obscure events, or make things seem other than what they are.

Some small business owners have been known to reduce prices when learning of an IRS, state, or sales tax examination, in an effort to reduce the eventual adjustment based on a percentage markup calculation. Aware of this strategy, IRS examiners are instructed to record a sample of prices on key services; later these can be compared to receipt books, logs, or other documentation. If the cash receipts or documents are missing, the taxpayer cannot verify that prices were either higher or lower. Thus guilty, unable to prove they are innocent under our tax laws.

Types of Audits

While IRS audits have been around for a number of years, there are still a number of misconceptions about what triggers an audit—or how to avoid one. For instance, because a refund check has been received doesn't mean that an audit is out of the question. Audit determination is usually made long after the refund check is issued.

The IRS can choose one of two ways in which to audit tax returns: an examination conducted either through the mail or in-person via a personal interview. An IRS audit conducted through the mail is known as a correspondence audit. Its scope is usually less than that required for an office audit.

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It is at this point that the contractor, dealer, or supplier's own actions can reduce the possibility of a more extensive examination. Give the IRS the answer before they ask the question, pointing out "oddball" items on the tax return. For large transactions that may fall into one of the innumerable "grey areas" of our tax laws, Form 8275, "Disclosure Statement," may help avoid penalties by disclosing questionable deductions, positions, or investments. Few experts think using this form will increase the chance of being audited.

The development and publication of Audit Technique Guides are designed to assist IRS auditors. The guides are written so that auditors know what practices to look for when auditing businesses in specific fields or, in this latest release "cash intensive businesses." The guides, however, are available to everyone, providing a goldmine of information that can help steer every pressure cleaning business away from potential tax pitfalls, while helping keep auditors away from the door. The IRS's website offers a number of industry-specific ATGs along with the complete ATG for "cash intensive businesses" (**www.irs.gov**). CT