

# PUBLICATION

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## IRS Auditing Update: Agents Now Want Full Data Copies of QuickBooks

September 19, 2011

In 2010, the Internal Revenue Service (IRS) began training approximately 1,100 Revenue Agents in the use of QuickBooks. In addition, the Service began routinely asking for the full data copy of the software from business owners, telling the owners that such requests had become standard operating procedure. The Service chose to train revenue agents in the use of QuickBooks because nearly 85 percent of small business owners use QuickBooks for their accounting and bookkeeping needs. Many franchisors also require franchisees to use QuickBooks as their general ledger, with a custom template or chart of accounts prescribed by the franchisor to facilitate reporting and benchmarking.

### Background – Closing the Tax Gap

In a study performed in 2001, Treasury determined that the difference between what should be collected in revenue, as opposed to what was actually being collected in revenue (tax gap) was greatest in the non-farm small business sector. According to this study, the compliance rate was only 43 percent among small business owners. Closing the small business tax gap, estimated by the Treasury's study at \$109 billion per year, has been identified as a top priority by IRS officials. IRS demands for the full data file create legitimate taxpayer concerns and are viewed by critics as being well outside the historical scope of the tax audit process.

Formerly, upon receipt of an audit letter, the taxpayer and its tax advisor would collect the necessary support and provide documentation in response to specific issues (i.e., there was a defined request and a specific response). Generally, the consensus among most tax professionals has always been to provide information specifically requested unless that information is outside the proper scope of the Service's administrative summons authority. The primary concern with the Service's more recent full data file request focuses on certain data frequently stored in the QuickBooks file that is clearly (at least in the opinion of many practitioners) outside the boundaries of what the IRS can compel a taxpayer to produce.

### Small Business Software

Income and Expenses Versus Customer Information. QuickBooks software is used by most small businesses perhaps because it is possibly the best accounting software for the price. The rub is that unlike the more sophisticated accounting software used by larger companies, access cannot be restricted when QuickBooks is provided to an IRS agent. The more sophisticated accounting software enables the company to limit and control the flow of information to the IRS agent by printing specific reports, or providing an electronic copy that permits access only to the items open in the audit. However, QuickBooks allows the agent unfettered access to the full accounting and financial history of the company since the implementation of the software for any tax years that have not been condensed to summary reports without the original entry and worksheet data. In addition to the full disclosure on the financial and accounting side, such software provides the agent with unlimited access to sensitive customer and vendor information that is beyond the scope of the audit's authority.

For the same reasons, franchisors prefer to specify QuickBooks so their "desk audits" of franchisees can access the raw data of the general ledger. The cat and mouse game of revenue underreporting is thus harder to play. Conversely, solid, accurate data on expenses will assist the franchisor and franchisee in developing

strategies for improving underperformance and spotting issues before the franchisee enters dire financial straits.

Data-Mining. The Service desires to have the data in electronic form in order to more quickly and efficiently mine the data by producing specified reports. The primary purpose driving the Service's initiative appears to be increased efficiency during the audit process. The Service states in its Frequently Asked Questions and Answers section on accounting software, dated April 18, 2011, that the electronic records will be requested in a majority of cases and the software will generally permit further corroboration of a taxpayer's tax returns through "drilling down" to underlying data and the generation of various reports without needlessly expending the agent's time requesting documents, or the taxpayer's time filling such requests.

AICPA Input. The American Institute of Certified Public Accountants (AICPA) addressed the concerns of small business owners in a letter dated March 29, 2011, to the IRS. In that letter, the AICPA suggested that small businesses using QuickBooks should be able to provide a redacted electronic copy, similar to the ability of larger companies with more sophisticated accounting software, which would permit the company to provide only the relevant data. Unfortunately, this offer was rejected by the IRS.

### **Service's Position and Pertinent Law**

Frequently Asked Questions and Answers. The IRS has addressed various issues in its Q&A regarding the recent requests for electronic records, and confirmed that agents will typically request the QuickBooks data file in the initial stages of the audit. The Service points to § 6001 of the Internal Revenue Code as its statutory authority for requesting electronic files and makes clear that if a "customer" (the IRS euphemism for the taxpayer under audit) refuses to voluntarily comply with the request, then the Service has the right to issue a summons for the information and/or disallow the items reported. Additionally, the Service states that if a taxpayer's representative refuses to provide the backup file, the representative could be in violation of Circular 230, an IRS publication issued several years ago that addresses and regulates the practice of attorneys, accountants and others before the Service.

In addressing whether a taxpayer could provide only the data for the tax year(s) under examination, the Service (consistent with its response to the AICPA) states that such a file would not satisfy "the requirements or the needs of the IRS" and that the file would not "meet the requirements of the Information Document Request or a summons and the taxpayer's representative could be in violation of Circular 230."

Pertinent Law. The two sections of the Internal Revenue Code relied upon by the IRS include §§ 6001 and 7602.

- § 6001 mandates that taxpayers must maintain appropriate records to substantiate tax returns.
- § 7602 permits the IRS to examine relevant records for the purpose of ascertaining the correctness of any return.

In *United States v. Rouse*, pending before the U.S. District Court in Tampa, Florida, the court addressed an IRS summons to a small business owner for the production of an electronic copy of the taxpayer's QuickBooks software. The taxpayer refused to comply with a December 2010 summons. In response to the taxpayer's refusal, in April 2011 the court entered an Order to Show Cause as to why taxpayer should not be compelled to comply with the summons, and directed the parties to appear before the court in June 2011.

In the *Rouse* case, the U.S. Magistrate Judge relied upon a 1964 United States Supreme Court decision in *U.S. v. Powell* and held in a Report and Recommendation dated June 27, 2011, that "[i]n order to establish a prima facie case for enforcement, the government must show:

1. That the investigation will be conducted pursuant to a legitimate purpose;
2. That the inquiry may be relevant to that purpose;
3. That the information sought is not already within the IRS' possession; and
4. That the administrative steps required by the Internal Revenue Code have been followed."

Interestingly, the taxpayer in *Rouse* did not attack the third requirement by arguing that the same information could be provided to the revenue agent in hard copy form and that the entire data file was not necessary. Instead, the court was presented with the relatively narrow issue of whether § 7602 applied. The taxpayer argued that a request for an electronic copy was outside the scope of § 7602. In response, the Magistrate Judge held that under a plain reading of § 7602, which, in relevant part, states that the IRS may "examine any books, papers, records, or other data," that the term "other data" includes electronic backup files in that case. This holding is arguably consistent with the Service's Rev. Proc. 98-25, in which the IRS states that the requirements of § 6001 that apply to hard copy records also apply to electronic records.

Is This The End? While some commentators have suggested that the Service is now entitled to electronic copies of accounting software, these commentators may overstate the scope of the decision of the Magistrate Judge in the *Rouse* case. Other courts may determine that the IRS has overstepped its statutory summons authority. Either way, unless and until the issue is settled in favor of the taxpayer, the overall scope of the IRS audit has increased exponentially, both increasing the cost of audit defense and providing an opportunity for zealous and aggressive IRS agents to overstep boundaries.