

# PUBLICATION

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## IRS Notices Issued to Small Businesses on a Hunch

September 5, 2013

Many small businesses have begun to receive notices (often styled as a "Notification of Possible Income Underreporting") from the IRS as a result of the information reported on Form 1099-K. Although receipt of this notice does not necessarily indicate that a business is currently under audit, failure to sufficiently address the IRS's concerns or a failure to respond could result in an audit being initiated or worse, an assessment for unpaid taxes.

Form 1099-K is an information return prepared annually by banks and other financial institutions that process credit and other electronic payments to merchants (e.g., PayPal), otherwise known as payment settlement entities, or PSEs. Generally a business should expect to receive a Form 1099-K from each of its PSEs in late January if, during the prior year, the PSE processed a minimum of 200 transactions totaling at least \$20,000 in gross payments for the business. The PSEs are also required to send a copy of each Form 1099-K to the IRS.

The notices relating to Form 1099-K were initiated by the IRS last fall and continue to be mailed to businesses. These notices are usually sent to a business based on either a mismatch between the gross payment amount reported on Forms 1099-K and the gross income reported by the business on its federal income tax return or an unusually high proportion of its reported gross income being attributed to the payments reported on Form 1099-K, which the IRS believes indicates a strong possibility that cash and other forms of revenue have gone unreported.

Because the gross payment amount reported on Form 1099-K does not account for merchandise returns, charge-backs, sales tax or gift cards (businesses are not required to report the income from gift card sales until the card is used), there is almost always a mismatch between the gross payment amount and the gross income the business is required to report on its federal income tax return. Likewise, the IRS's utilization of these information returns to identify cases of potential underreporting often results in unfounded fishing expeditions that can be cut short with the appropriate response. Accordingly, businesses that receive these notices should immediately contact a tax professional familiar with these notices, and then begin the process of collecting records that relate to the period(s) in question so that a structured plan of action can be put into place and an appropriate response sent to the IRS.

If your business receives one of these notices or any other notice from a federal or state agency involving its tax obligations, do not hesitate to contact any one of the attorneys in the Firm's Tax Group.