



## **IRS Issuing Form 1099-K Notices**

*Gary M. Sigman, CPA, MTax, PFS, AEP®*

The Internal Revenue Service is at it again. They are sending out notices to taxpayers who have reported gross sales that they feel are not consistent with the amount of sales that were reported on Form 1099-K. This form was first utilized in 2012, for the 2011 tax year. It's used by payment settlement entities (i.e., credit card companies) to report gross annual payments made to businesses in satisfaction of credit/debit card and other third party network transactions (i.e., PayPal).

Form 1099-K is intended to report gross payments received by a business entity. These gross payments may include not only sales, but sales tax, shipping, and other charges. These other charges may include tips, for a restaurant or bar. As you are probably aware, tips are not counted as income for the business, but, rather, for the recipient/employee.

When first conceived, the Internal Revenue Service was going to try and match the amounts from the 1099-K with the business' tax return. Such matching is already done with individual taxpayers as it relates to dividend/interest income, etc. However, business owners were not happy about having to undertake this task, and the extra internal costs that they would have to incur in order to comply. IRS listened to the complaints at that time and sided with the business owners. As a result, the Service agreed not to attempt to match the amounts per the 1099-Ks received with the amount of sales reported.

This softening stance, however, was soon to be modified. Beginning late last year, IRS began to send notices to businesses that reported lower than anticipated gross sales on their tax returns, based upon the government's examination of Forms 1099-K received on behalf of the business, coupled with their analysis of a taxpayer's industry and what the "normal" percentage of credit card receipts versus receipts of cash and checks are. These notices are titled "Notification of Possible Income Underreporting". When IRS initiates contact with a business concerning the 1099-K issue, it is similar to a scaled down audit. Not only does the government ask a business to confirm that the 1099-K(s) that were filed are accurate, but also wants an estimate of gross sales by category, and an explanation as to why its receipts from non-cash sources are out of line with their expectations. A business may also be asked to explain its internal bookkeeping process as it relates to the sales function, and if other items that are not considered income are included in gross sales, such as sales tax and shipping charges, among other things.

To further their agenda, the Service has also begun to send out notices threatening to begin "backup withholding", if the taxpayer's name and federal employer identification number (FEIN) reported on the 1099-K does not agree with their records. This would be quite onerous to a business, with the backup withholding rate at 28%, especially when this percentage is applied against gross sales. While this significant amount of withheld tax would eventually be refunded,

it would take some time to do so, since the refund would have to be requested on the business' tax return. To add insult to injury, if the business operates as an S Corporation or Partnership/LLC, each owner of the business would have to report the backup withholding on their personal income tax return, since this amount is reported on their Schedule K-1.

It can be a time consuming affair in not only preparing an adequate response to one of these inquiries, but one may have to wait two or three months for a response. In particular, if backup withholding takes place, it can have a detrimental effect on cash flow. It is therefore very important to make sure that all third-party payers have the correct business name and FEIN on file for a business. Finally, as is the case with any IRS notice, it is critical to respond in a timely and adequate fashion.

If you have any questions regarding this initiative, or have received such a notice and need to put together a response, please call one of the tax professionals at Zinner & Co. LLP.