

FOR IMMEDIATE RELEASE  
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**RE: BE AWARE (BEWARE) OF THE TAX GAP**

My friend, Don Kamin (Accounting Associates owner) recently returned from a national IRS tax forum and informed me that the IRS commissioners addressed the issue of the "Tax Gap" – the difference between what taxpayers should pay and what they actually pay. Two major components of the Tax Gap are the *underreporting* of small business income and the *overstatement* of expenses.

Owners of small, closely-held businesses typically enjoy many financial and tax advantages that the general workforce does not, including higher incomes, control

over their entrepreneurial destiny and tax write-offs – some legal, some not.

A sampling of the more common legal deductions would include: travel expenses

to business-related meetings and seminars, 50% of the cost of meals with business

associates, health-care benefits, amortized start-up expenses and depreciated equipment costs. Some of the "overstated abuses" include non-business-related travel, entertainment and meals, personal use of company auto, personal use of company credit cards, consumption of company supplies, "skimming" from the cash drawer and other imaginative "slight of hand."

To determine the extent of the Tax Gap, the IRS surveyed 46,000 businesses. The survey showed that the missing taxes from small businesses alone may be in the neighborhood of \$109 billion - a neighborhood the IRS now wants to excavate.

In another study, the California Franchise Tax Board identified the types of businesses that had the highest noncompliance rates. Antique dealers led the list with a tax underreporting rate of 60 to 70 percent. Next were restaurants (55 – 65%), used car dealers (45 – 55%), auto repair shops (40 – 50%) and landscaping businesses (35 - 45%). Some of the noncompliance was willful and some was due to ignorance of the law.

Based on my experience, New Mexico would probably fall into line with the California statistics. In fact, I would submit that 75 to 85% of the small

businesses which handle “cash” sales are likely to be guilty of some skimming.

According to the IRS, business owners are required to report all income including the usual (cash, checks, credit, interest and dividends), as well as the unusual (barter, rent, cancelled debts, promissory notes, damage awards, injury payments referral fees and kickbacks). As a result, the IRS is stepping up its enforcement efforts by increasing the number of audits, and subsequently, assessments for offenders.

The IRS will also utilize additional third-party reporting requirements, such as asking financial institutions to report *basis* (the sales price minus the purchase price) to determine the taxable capital gain on a transaction. In particular, the IRS will focus on analyses and audits of S-Corporation tax returns. This will have a direct impact on future business sales.

How can small business owners prepare for this new IRS assault? Of primary importance is for them to review and update their books and records. Many small corporations and LLCs have not updated their corporate minutes and other records to conform with IRS requirements. Financial documents must also be reviewed to make sure they are both accurate and complete. In some cases it may be prudent to amend past tax returns to stave off an unwanted audit and possible penalty and interest charges.

By using preventive maintenance measures consisting of better record keeping and the exercising of “write-off restraint,” small business owners can weather the storm associated with this new IRS focus.