

Latest IRS Targeting Scandal May Hit Lawyers

By Robert W. Wood

Some lawyers say the best defense is a good offense. It can be especially effective to divert attention away from your weaknesses. The Internal Revenue Service may be taking a page from the books of defense lawyers as it simultaneously defends itself and goes on the attack. The tax agency is still under scrutiny for targeting of political groups.

That controversy resulted in President Barack Obama firing one IRS chief and appointing another. One key IRS official in the tax exemption controversy continues to assert her Fifth Amendment rights. Amid the turmoil, much seems to be about who knew what when, and precisely who directed employees. Some of it reads like an Abbott and Costello routine.

Meanwhile, the IRS is also under criticism for lavish conference and travel spending. This is one issue among many within the IRS concerning accountability. Yet as it faces these issues, the tax agency is doing some targeting of its own, fingering at least 20,000 small businesses in a strange “please explain” campaign. And that number will grow.

The scrutiny on small business taxpayers in this way is a little frightening. Small business people across America are receiving IRS notices, and some may well be lawyers. More notices will be coming. The IRS acknowledges that it is collecting data about cash and credit card payments and matching them up to returns where it can.

The IRS gathers data from many third parties — including credit card companies — to see if taxpayers picked up every nickel of income. The IRS is looking at Form 1099 matching, including merchant reporting of credit cards. More insidiously, the IRS uses average statistics for comparison. The controversial IRS notice is titled “Notification of Possible Income Reporting.”

Although the IRS claims it is merely gathering information and not accusing anyone of failing to report income, not everyone is convinced. One Congressman, Sam Graves (R-Mo), chairman of the House Committee on Small Business, points out that the IRS notice’s first sentence begins, “Your gross receipts may have been underreported.” It sounds like the IRS is looking for more than just additional information, says Congressman Graves.

The notices could mean more taxes, penalties and interest, Congressman Graves wrote to the IRS. See Letter From Rep. Graves to Faris Fink, IRS Commissioner for Small Business and Self-Employed (Aug. 9, 2013). The congressman believes that any such letter from the IRS is likely to intimidate businesses. He argues that a small business owner receiving this notice may be alarmed and even feel threatened. The IRS notice goes on to state that your receipts are off from an IRS average. Within 30 days, you must provide documentation to prove why your numbers don’t fall within the IRS’s standard.

Yet the IRS doesn’t reveal its sources, doesn’t define the standard, and doesn’t say where it came from. It sounds like you are being asked to prove that you didn’t underreport your income. That’s proving a negative, and could require extensive correspondence and documentation.

Could this impact lawyers in particular? Yes, given the web of special Form 1099 reporting that applies to lawyer fees. Section 6045(f) of the tax code was added by the inaptly named Taxpayer Relief Act of 1997. It imposed new burdens on payors and recipients of attorney fees.

First, one should distinguish between the regular Form 1099 rules and the special rules for attorney fees. Clients should issue Forms 1099 to lawyers and law firms for payments of services even if the law firm is a corporation. For many years, payments to corporations were exempt from Form 1099 reporting. Now, however, Section 6045(f) requires Forms 1099 for all payments to lawyers and law firms for services.

A Form 1099 is required for lawyer fees even if the law firm is incorporated. In effect, the “issue a Form 1099 to every lawyer” rule trumps the rule that one need not issue Forms 1099 to corporations. Lawyers need to issue the forms, too. Lawyers who pay independent contractors, co-counsel, etc. over \$600 must issue Forms 1099 for payments.

That brings us to credit cards. In 2008, Congress added Section 6050W to the tax code requiring merchants and third-party settlement companies to issue Forms 1099 reporting all credit card transactions. The form is a 1099-K, and all lawyers and firms taking credit cards should beware of it.

Suppose that your law firm accepts MasterCard, Visa and American Express payments for hundreds of clients over the course of a year. You may use one credit card processing company or several. Each credit card processing company and each third-party payment aggregator must now issue your firm a Form 1099-K reporting the total amount processed. That doesn’t seem so bad, right? You have to report the payments as income anyway, so where’s the harm?

The potential harm comes in several ways. First, this is gross payment reporting, not net. The IRS will be told you received the total of the full charge, not the net amount (after processing fees) you actually received. Plus, if you accept a credit card payment as a retainer but haven’t yet earned it, it is not income. The IRS may assume it is.

It is clear that the IRS is mining this credit card data. The IRS letters to small business alluding to possible under-reporting suggest that the IRS believes a high percentage of credit card transactions may mean you are not reporting all the cash you receive. “Please explain,” the IRS asks. Yet there may be innocent explanations. Why might a business report high card receipts compared with cash? If most items sold are for high dollar amounts, cards may be the norm. Plus, card receipt totals can include cash the customer takes back.

Sales tax is another huge issue, since it isn’t income to the business that collects it from customers and sends it in to the state. Gift cards too result in a mismatch. Any or all of these may account for the difference. As a result, many are now criticizing the IRS.

But the IRS defends its campaign as measured and equitable. The agency suggests that many businesses, including mom-and-pop ones, fail to report all their cash sales. The IRS is merely trying to determine who is reporting what, the IRS explains. But with compliance costs already high for many small businesses, this latest campaign seems unlikely to win the IRS any relief from already mounting criticism.



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