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underreporting letters

Jim Buttonow • Aug. 28, 2013

The IRS has always been able to match individual tax returns against information statements and propose underreporter adjustments that come in the form of CP2000 notices. ??But things are changing, and a new era at the IRS is upon us. ??Now, the IRS is using information statements to find underreporting on business returns. For practitioners across the country, this will add to the already increasing level of post-filing compliance activity they are seeing. ?

More Interest in Business Income ??

In September, the IRS started its first information return-matching program for business return Forms 1120, 1120S and 1065. This program matched business return incomes to the total amounts reported on all information returns. ??

This year, business taxpayers also started receiving Form 1099-K, *Merchant Card and Third-party Network Payments*, reporting amounts received from payment settlement entities (from debit/credit cards and third-party network payers such as PayPal). To avoid taxpayer burden, the IRS stated in a [letter](#) to the National Federation of Independent Business on Feb. 9 that it will not require taxpayers to separately report amounts from Forms 1099-K on returns, and has no plans to in the future. ??

On Nov. 16, the IRS announced that it will start questioning businesses with smaller-than-expected income, based on its analysis of Forms 1099-K reported to the business. Interestingly, the IRS cannot propose specific adjustments to the return because it can't match Forms 1099-K directly to line items on 2011 business returns. However, the IRS is contacting taxpayers when it thinks that there is a discrepancy. The IRS determines this probability based on the taxpayer's line of business and a

perceived disproportionate share of credit/debit card and third-party network

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underreporter program used for individual income discrepancy adjustments

The NATP reported that the IRS will send out about 20,000 letters to small businesses.

The Notices to Expect

As part of this initiative, the IRS created four new letters that question business returns with possible unreported income, based on a Form 1099-K analysis. These letters question the accuracy of your client's return.

Each letter provides information on the reported gross receipts on the return, as well as the total amount for Form 1099-K payments received. The letter will also provide information on the specific Forms 1099-K filed on your client's business.

If your client receives Letter 5035, 5036, 5039 or 5043, *Notification of Possible Income Underreporting*, your client may have underreported gross receipts. The IRS compared the amount in gross receipts reported on the return to the amount in receipts from merchant card payments on Forms 1099-K. Based on the IRS' analysis of your client's industry (presumably using the merchant category code on Forms 1099-K), the IRS thinks that your client may have more income than what is reported on the filed return. Depending on the letter, your next steps vary.

Here's how to respond to each letter.

Letter 5035

Actions requested by the IRS: Review the accuracy of the information shown on the notice and the filed return.

How to respond: This is a soft notice, which doesn't require a direct response. Your

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How to respond: This notice has the potential for an IRS underreporter assessment or audit. Respond to the IRS with one or more of the following actions, depending on your client's situation:

- A description of inaccurate Form 1099-K information listed on the notice
- An amended return filed for additional gross receipts
- An explanation that the return and the Form 1099-K information shown on the notice are accurate, and an explanation for why the business's gross receipts from card payments are higher than expected

Deadline: 30 days; the IRS provides a fax number for responding

Possible next actions by the IRS: The IRS does not specify its possible next actions with this notice. However, Publication 3498-A, *The Examination Process (Examinations by Mail)*, is attached, indicating that if your client doesn't respond to this notice, a discrepancy adjustment notice or a mail examination could result.

Letter 5039

Actions requested by the IRS: Review the accuracy of the information shown on the notice and the filed return. Complete Form 14420, *Verification of Reported Income*.

How to respond: This notice has the potential for an IRS underreporter assessment or audit. The IRS requires a completed Form 14420 in your response.

Deadline: 30 days; the IRS provides a fax number for responding

Possible next actions by the IRS: The IRS states four possible next actions:

- The IRS will contact your client if it needs additional information.
- The IRS might propose an adjustment to the taxes due.

- The IRS might send a letter stating that no further action is required.

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or audit. Respond to the IRS with one or more of the following actions, depending on your client's situation:

- A description of inaccurate Form 1099-K information listed on the notice
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Deadline: 30 days; the IRS provides a fax number for responding

Possible next actions by the IRS: The IRS states four possible next actions:

- The IRS will contact your client if it needs additional information.
- The IRS might propose an adjustment to the taxes due.
- The IRS might send a letter stating that no further action is required.
- If your client doesn't respond to the notice, the IRS might propose an additional tax assessment, underreporter assessment or audit.

Completing Form 14420, *Verification of Reported Income*

The IRS provides a new two-page form to reply to Letter 5039: Form 14420, *Verification of Reported Income*. The form requests:

- Verification of the accuracy of Forms 1099-K filed under your client's name
- Estimates of gross sales by Form 1099-K reportable transaction categories (such as online, phone or catalog, gift cards, lottery tickets) to explain why the portion of gross receipts is higher than expected
- Information on other individuals or businesses that shared a card terminal with your client and would have received merchant card receipts reported on your client's account

The IRS estimates that it will take three to six hours to prepare, copy and send Form

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However, the IRS is attaching Publication 3498-A, *The Examination Process (Examinations by Mail)*, to most of the letters. This indicates that the IRS intends to assess additional tax using deficiency procedures – similar to how the IRS assesses tax in CP2000 individual underreporter inquiries and audits.

IRS underreporter inquiries and audits can be time-consuming, even by IRS estimates. Responding to the IRS using best practices saves time for you and your client. See how [Beyond415](#) guidance and workflow products can help your firm use best practices in post-filing compliance work to address emerging IRS initiatives, including business underreporter inquiries and audits.

Jim Buttonow, CPA, CITP, is Vice President of Product Development and Cofounder of the tax technology company New River Innovation. Jim's professional mission is to apply emerging technology to problems faced by tax professionals after they file.

Jim is a CPA and former IRS Large Case Team Audit Coordinator. He worked at the IRS for 19 years. Since leaving the IRS, Jim has represented many clients before the IRS. At New River Innovation, Jim is the chief architect of Beyond415 ([Beyond415.com](#)), an award-winning technology for tax practitioners to efficiently handle IRS issues, notices and audits. Through Beyond415, Jim also develops and presents CPE series on IRS practice and procedure for issues that arise after filing, such as audits, notices and discrepancies. Jim regularly speaks on compliance trends and post-filing practice efficiency strategies for CPA and accounting firms.

Jim's articles and blog posts have appeared in The Wall Street Journal, CPA Practice Advisor, Journal of Accountancy and various state CPA society magazines.

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