SOUTH JERSEY Biz

OFFICE SPACE
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Corner Office: Red Flags and Tax Audits in Cash Intensive Businesses

by Jo-Ann Weiner, CEO and Founder, J.L. Weiner and Associates, LLC

Cash Intensive Businesses

A cash intensive business is one that receives a significant amount of receipts in cash. Think of as many businesses as you can that deal in cash such as hair salons, pizzerias, restaurants, laundromats, car washes, convenience stores. Some of these businesses handle a high volume of small dollar transactions.

Receiving cash in your business is not the problem—how cash is or is not accounted for in your business records is the problem. A process needs to be put in place to ensure the cash is deposited and recorded as income. The question each IRS tax auditor will ask is: How are your gross receipts calculated? They will also ask if all income was reported.

Think about it—if your business gross receipts are arrived at by adding deposits to your bank accounts but cash received is not on deposit to the account, all income is not reported.

In addition, if expenses are paid with cash not on deposit, the expense will not be allowed. The cash must be included in income and then the expense can be allowed. Of course, that procedure casts doubt as to the reliability of the records.

From a practical point of view, it is very important that there be a separation of duties regarding employees who accept cash, deposit cash and record it. A fuller conversation of that topic would be needed at another time.

Minimum Income Probes

Did you know that minimum reviews of your income are done on every federal tax audit? You or your representative should therefore perform a review of your income in preparation of the audit. Take a look at your deposits. Do they exceed reported income? If so, are there non-taxable items on deposit such as loans, gifts or inheritances that can be backed out of deposits? Do you withdraw money and redeposit it? Non-taxable items and redeposits could cause your income to look higher than it actually is.

Be sure to keep your business funds separate from your personal funds. When funds are mixed it is called "co-mingling of funds" and it could cause income to look as if it is higher than it actually is, or it could be viewed as poor record keeping practices or an attempt to mislead.

Indicators used to Justify the Auditor to Take a Closer Look at your Financial Condition

There are several items that will trigger the IRS taking a closer look at your financial condition:

- Books and records do not reconcile to your tax return
- Excess unexplained deposits
- Inadequate internal controls
- Co-mingling of funds
- No income on deposit
- Using cash instead of depositing it
- Financial activities do not appear in balance with your return
- Gross profit changes on your prior and subsequent returns are inconsistent

So, if your income is low but you purchased a new Ferrari or took several expensive vacations, the returns will not support those activities and that provides a reason to justify a closer look at your financial condition. Remember, as a rule cash is not the problem—how one reports it and how it is accounted for is the issue.

Jo-Ann Weiner is the owner of J.L. Weiner and Associates, LLC.