

Chapter 6

Indirect Methods of Reconstructing Income

CHAPTER SUMMARY

Overview

This chapter identifies the major indirect methods of proof used by the IRS, discusses the significance and application of these methods from the viewpoint of an IRS agent, and describes which method is appropriate for each type of business. Understanding the IRS practices helps a forensic accountant gain an understanding of the special tools and concepts involved in the indirect methods.

Forensic Audit Approaches Used by the IRS

The IRS's use of indirect methods exemplifies the pros and cons of techniques that can prove fraud as well as invade taxpayers' privacy. In the plus column, indirect methods have been used in the successful prosecution of a significant number of criminal tax fraud cases. In the negative column are listed overzealous intrusions of privacy by agents, prompting congressional limits to be imposed.

¶6001 Minimum Income Probes

The use of indirect methods to reconstruct income by the IRS is limited by Code Sec. 7602(e), which prohibits financial status or economic reality techniques to determine the existence of unreported income unless the agent has a reasonable indication that there is a likelihood of such unreported income.

The Internal Revenue Manual sets forth minimum income probes. For nonbusiness returns (having no Schedule C or F), an agent is to question the taxpayer or the representative about possible sources of income other than reported on the return. If there is no other information in the file indicating potential unreported income, the minimum income probe is met. However, for taxpayers who are self-employed and file a Schedule C or F, an analysis is made from tax return information to determine if reported income is sufficient to support the taxpayer's financial activities.

¶6011 Lifestyle Probes

Just like an IRS agent, a forensic accountant should be aware of the lifestyles of employees of companies as well. The lifestyle of a taxpayer or employee may give clues as to the possibilities of unreported income.

¶6021 IRS's Financial Status Audits

The theory in the use of lifestyle audits is valid for both IRS agents and private sector forensic accountants. If someone is spending beyond his or her apparent means, there should be a concern. If a forensic accountant suspects fraud or unreported income, a form of financial status audit may be appropriate that will enable the investigator to check the lifestyles of the possible perpetrators.

Indirect Methods

An indirect method should be used when the taxpayer has inadequate books and records, the books do not clearly reflect taxable income, or there is a reason to believe that the taxpayer has omitted taxable income. An indirect method also is appropriate when there is a significant increase in year-to-year net worth, when gross profit percentages change significantly for that particular business, or when the taxpayer's expenses (both business and personal) exceed reported income, and there is no obvious cause for the difference.

¶6031 Market Segment Specialization Program

The Market Segment Specialization Program focuses on developing highly trained examiners for a particular market segment. A market segment may be an industry such as construction or entertainment, a profession like attorneys or real estate agents or an issue like passive activity losses. An integral part of the approach used is the development and publication of Audit Technique Guides. These Guides contain examination techniques, common and unique industry issues, business practices, industry terminology, and other information to assist examiners in performing examinations.

¶6041 Cash T

For a taxpayer who files a Schedule C or F, an agent may prepare a cash transaction account (cash T) to determine the understatement of income. A *cash T* is an analysis of all of the cash received by the taxpayer and all of the cash spent by the taxpayer over a period of time. The theory of the cash T is that if a taxpayer's expenditures during a given year exceed reported income, and the source of the funds for such expenditures is unexplained (e.g., taxpayer had no loans or nontaxable sources of income), such excess amount represents unreported income.

An agent is instructed to question a taxpayer regarding beginning and ending cash-on-hand and to specifically inquire regarding the existence of a cash hoard. A cash hoard consists of money that is not in a bank account, or other readily verifiable location that the taxpayer alleges should be in the beginning cash balance.

¶6051 Source and Application of Funds Method (Expenditure Approach)

The *source and application of funds method* (also referred to as the *expenditure method*) was approved for IRS use by the Supreme Court in 1942. This technique is a variation of the net worth method (discussed later in this chapter) that shows increases and decreases in a taxpayer's accounts at the end of the year. Often the IRS agent uses the expenditure approach when a taxpayer is spending income lavishly rather than purchasing assets or investments.

The expenditure approach is similar to the cash T, except that the data used is the increases and decreases in the taxpayer's accounts. The format of this method is to list the applications of funds first and then subtract the sources (see Figure 6.3). If the taxpayer's known cash sources exceed his or her known cash receipts (including cash on hand at the beginning of the year), any difference is unreported income.

¶6061 Net Worth Method

The net worth method is a common indirect balance sheet approach to estimating income. To use the net worth technique, an IRS agent must calculate the person's net worth (the known assets less known liabilities) at the beginning and ending of a period. The agent adds nondeductible living expenses to the increase in net worth. If there is a difference between the reported income and the increase in net worth during the year, the agent tries to account for the difference as (1) nontaxable income and (2) unidentified differences. Any unidentified difference may be an approximation of the amount of a theft, unreported income, or embezzlement amount (e.g., an inference of unreported income).

¶6071 Bank Deposit Method

Whereas the focus of the net worth method is on the year-end bank balances, as well as other assets and liabilities, the bank deposit method looks at the funds deposited during the year. This method attempts to reconstruct gross taxable receipts rather than adjusted.

The bank deposit method is appropriate when most of the income is deposited in banks and most of the expenses are paid by check. This technique may be used to audit income of physicians or dentists who normally receive payments from patients and insurance companies in the form of checks as mentioned in the *Boulet* case. A formula for computing gross income taken from the Internal Revenue Manual is shown in Figure 6.4, and Figure 6.5 shows business gross receipts.

¶6081 Contract and Procurement Fraud

Contract and procurement frauds are an international problem, with bribery the most damaging of these corrupting schemes. Often disguised as some type of exchange, the normal bribe/kickback involves something of

value being transferred to someone and a later influence of a business or official action. The duty to cooperate and audit rights are two important concepts to fight this corruption. Indirect methods may be used to catch procurement fraudsters.

¶6081 Conclusion

Although Code Sec. 7602 limits the use of indirect methods, the Code does not prohibit or preclude its use. Until better methods of determining unreported income are provided, the IRS will probably continue to use the methods discussed in this chapter and sanctioned by tax law. The lack of better or less costly methods of determining taxable income for persons who are self-employed provides motivation for future research in this area. Likewise, forensic accountants may use these methods under appropriate circumstances. The lifestyles of taxpayers and employees may give clues to the possibility of unreported income or fraud.
