FINANCIAL STATUS AUDITS:

A RETURN TO BASIC INVESTIGATIVE TECHNIQUES

BY THE INTERNAL REVENUE SERVICE !

by

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The Internal Revenue Service recently has implemented its "Financial Status" or "Economic Reality" approach to audits. Financial Status audits represent a significant movement away from merely attempting to verify information set forth on a taxpayer's return. It is the process of gathering sufficient information during the course of an audit to "profile" a taxpayer to determine whether information set forth on the taxpayer's return accurately reflects their true financial status. Agents have already been trained to focus on whether reported income is sufficient to support various financial aspects of the taxpayer's lifestyle or business activities. Financial Status represents a substantial effort by the Internal Revenue Service to increase compliance and seek out potentially fraudulent situations.

The Financial Status effort is enhanced as a result of the "Compliance 2000" Program and the Market Segment Specialization Program (MSSP) of the Internal Revenue Service. Under its Compliance 2000 Program, the Internal Revenue Service has been attempting to identify and reduce non-compliance through legislative changes, tax form simplification, education, and enforcement. The Compliance 2000 Program was based in significant part upon a belief that there was a widening "Tax Gap" (the Tax Gap represents the amount of taxes due for a given year that are not voluntarily paid). For 1992, the Tax Gap was estimated to be $105 billion for individual income taxes, $39 billion for employment taxes, and $33 billion for corporate income taxes, a total estimated tax gap of $177 billion.

The system of taxation within the United States is based upon voluntary compliance. In recent years, for various economic and other reasons, it appears that the level of voluntary compliance has diminished. An effective enforcement mechanism is required in order to increase the level of voluntary compliance. The MSSP has been designed to improve compliance by focusing on taxpayers as members of particular groups. These groups have been defined by type of business (i.e., gas stations, grocery stores, etc.), technical issues (i.e., passive activity losses), types of taxpayer (i.e., returns lacking economical reality), or method of operation (i.e., cash businesses). As agents have focused on the tax compliance of a particular group, they have gained experience on specific issues to be examined for particular types of businesses, whether or not the issues are set forth on a return. Under MSSP agents are attempting to reconcile discrepancies when income and/or expenses set forth on a taxpayer's return are inconsistent with the typical market segment profile or where the reported net income seems inconsistent with the standard of living prevalent in the geographic area where the taxpayer resides. As a result, the taxpayer's economic lifestyle

becomes a barometer for judging the accuracy of the taxpayer's returns based upon information developed through MSSP and audits of other taxpayers.

Financial Status audits should serve to bring many taxpayers back into compliance, including taxpayers undergoing audits and taxpayers aware of the fact that such audits will occur. Compliance studies conducted by the Internal Revenue Service determined that net income reported on many returns was insufficient to sustain the taxpayer's business, ongoing businesses reported continuous losses, certain businesses reported profits far below industry standards, certain taxpayers reported taxable income below the poverty level, and many taxpayers enjoyed lifestyles that simply did not correspond to the information set forth on their returns. As a result, the Internal Revenue Service determined that it should refocus its efforts on investigative techniques, rather than mere verification of the return information.

During the course of a Financial Status audit, an agent will attempt to complete a Personal Living

Expense ("PLE") checklist that includes an analysis of the taxpayer's expenditures for food (at home and away from home), housing (if owned by the taxpayer there will be a determination of expenditures required for mortgage interest, property taxes, maintenance, repairs, and insurance), utilities, clothing, transportation (if a vehicle was purchased, the agent will attempt to determine the deposit and finance charges, repairs and maintenance expenses, gasoline expenditures, and expenditures for public transportation), healthcare (health insurance, medical services, prescription drugs, and medical supplies), entertainment, personal care, education (i.e., college expenditures), cash contributions, personal insurance and pension contributions.

In attempting to determine the level of compliance set forth on a return, agents will also attempt to interview the taxpayer. It is likely that the agent may seek to interview the taxpayer near the commencement of the audit, before the taxpayer has an opportunity to formulate responses for any potentially sensitive issues. If the representative lacks first-hand knowledge, there is a strong likelihood that the agent will seek to interview the taxpayer directly. If the request is denied, the agent may issue a summons requiring the taxpayer to attend. The agent may utilize the infamous unofficial "27 Questions" as an informal outline for the interview.(1)

Even if the taxpayer's books and records appear satisfactory and internally consistent, Financial Status audits dictate a further review of information relevant to the particular taxpayer or the taxpayer's business industry as might be evident by an unrealistically low income for the nature of the business, bank deposits substantially in excess of reported gross receipts, a lifestyle inconsistent with reported income, or repeated reported business losses. In a business context, the agent will likely demand a tour of the business premises to get an understanding of the scope of the business activity or to confirm a claim on the return regarding ending inventory, wage deductions, etc. Further, if the return information fails to support any relatively high asset-related deductions, the agent can be expected to inquire about the source of the revenue that allowed the taxpayer to accumulate the assets. In fact, several taxpayers have recently received audit reports from the Internal Revenue Service which included an imputed income adjustment explained as:

From records and information available, it has been determined that you received additional income in the amount shown from the sources indicated.

Imputed income is based on the following facts: Your ability to pay mortgage interest implies that you received income from known and unknown sources. The known sources are outlined. The unknown sources are based on the Bureau of Labor Statistics and the Average Consumer Debt. The computation is shown on the attached worksheet. The imputed income is considered self-employment income and is subject to self-employment tax.

Although Financial Status has been presented as a relatively new approach, seasoned agents have been utilizing various indirect methods of detecting a taxpayer's lifestyle or their level of business activity for years.(2) Historically, conventional audit techniques have been discovered to be grossly inadequate for the purpose of demonstrating an understatement of taxable income. In such event, the government has typically resorted to one or more indirect methods of detecting unreported income.(3) Although utilized extensively in potential civil and criminal tax fraud matters, the Financial Status approach implemented by the Internal Revenue Service can be anticipated to incorporate any of various accepted indirect methods of proof in what might otherwise be deemed a generic civil tax audit. In fact, there need not be, and usually will not be, a fraud component to trigger utilization of an indirect method in an audit.

The agent may pursue an indirect method although the taxpayer's books and records appear reliable. In fact, it is the indirect method that may provide strong evidence that the taxpayer's books are unreliable.(4) In Holland v. United States, the Supreme Court stated "To protect revenue from those who do not render true accounts, the government must be free to use all legal evidence available to it in determining whether the story told by the taxpayer's books accurately reflects his financial history."(5) Indirect methods of proof providing reliable estimates of the taxpayer's taxable income have been consistently affirmed on the basis that: "To require more would be tantamount to holding that skillful concealment is an invincible barrier to proof."(6) Agents utilizing an indirect method in a Financial Status audit can be expected to aggressively attempt to pierce this otherwise "invincible barrier." Accepted indirect methods of determining income include:

1. Net Worth Method

The net worth method is the most commonly used method of reconstructing income. It is merely an effort to determine whether there has been an increase in the difference between the taxpayer's assets and liabilities during the relevant tax year. Any unexplained increase in the taxpayer's net worth during the tax year is deemed attributable to current taxable income. The net worth method involves a reconstruction of the taxpayer's financial history since all assets, expenditures and sources of funds utilized during the tax year must be analyzed. It was first utilized in cases such as Capone v. United States, 51 F.2d 609 (7th Cir. 1931) to corroborate direct proof of specific unreported income. It is designed to seek out current unreported income that has been used by the taxpayer to acquire assets and requires the government to:

a) Establish a firm opening net worth at the beginning of the taxable period with reasonable certainty to provide a starting point from which to calculate future increases in the taxpayer's assets (which are included at their cost, not their fair market value);

b) Establish the taxpayer's net worth at the end of the taxable period, with any excess over the opening net worth plus non-deductible expenditures representing the "net worth increase" for the year;

c) Establish a likely source of currently taxable income from which the net worth increase arose, or negate any non-taxable sources of income and;

d) Investigate any reasonable leads furnished by the taxpayer that would tend to negate an increase in the taxpayer's net worth.(7)

The net worth method can be anticipated when there has been a noticeable change in the taxpayer's assets and liabilities during the year, the taxpayer maintains no books and records, or the taxpayer's books and records are inadequate, not available or withheld. The net worth method may also be utilized to corroborate other indirect methods of proving income and to check the accuracy of reported taxable income.(8)

2. Cash Expenditures Method (Source and Application of Funds Method)

The cash expenditures method is merely concerned with the flow of cash for expenditures and the relationship of those expenditures to any available sources of funds. The sources of funds must be further identified as either taxable or non-taxable. The theory of the cash expenditures method is that if the taxpayer's expenditures during a given year exceed reported income, and the source of funds for such expenditures is unexplained, the excess expenditures represent unreported income.

The cash expenditures method can be anticipated if there are only one or two years under examination, the taxpayer has attempted to skillfully conceal his income, there is little change in the taxpayer's assets and liabilities during the period under examination, comparative balance sheets for the taxpayer are available, or the taxpayer has little or no apparent net worth and most of the expenditures seem to constitute non-deductible living expenses.(9) Much of the information utilized by the agent in pursuing a cash expenditures analysis is typically obtained from interviews with the taxpayer and others. As such, it is extremely important for the taxpayer's representative to be familiar with the taxpayer's lifestyle and the nature of his or her business activities before determining whether to allow the taxpayer to be interviewed. Certainly, if there are sensitive issues, the taxpayer should not likely be subjected to the interview. If interviewed, the taxpayer must respond truthfully. In certain situations it is preferable to have the agent submit their questions in writing and to provide a written narrative response.

3. Bank Deposits Method

The bank deposits method is an attempt to reconstruct the taxpayer's taxable gross receipts. It is often used where the taxpayer is engaged in a business activity and regularly or periodically

makes deposits into bank accounts. It is limited not only to a review of items actually deposited, but includes a review of other income received by the taxpayer, not deposited.(10)

The bank deposit method involves an analysis of all deposits, canceled checks, and currency transactions of the taxpayer.(11) In addition, there must be a determination of "cash on hand" to overcome the taxpayer's possible assertion that unexplained deposits were derived from prior accumulated funds.(12) The agent must generally establish a likely taxable source of any unreported income and must overcome any credible claim of a cash hoard.(13) Further, the agent must establish with reasonable certainty the amount of cash on hand at the beginning of the tax year and must investigate any reasonable leads supplied by the taxpayer.(14) Although it appears to be a relatively simple test to perform, the bank deposit approach becomes difficult as the unexplained deposits begin to accumulate or account activity becomes excessive.

4. Mark-Up Method

The mark-up method is based on the premise that there are certain percentages or ratios between sales, cost of sales, and net profit that are common to similar businesses in the same locality. Therefore, a taxpayer's profits may be determined by applying an acceptable industry-wide percentage to reported gross sales, gross receipts, or costs of goods sold. The resulting figure is then compared to the taxpayer's reported profit to determine if an understatement may have occurred.(15) The mark-up method is typically used to corroborate results obtained from one of the other indirect methods or to help establish a source of income because it is the least likely to result in the reconstruction of gross receipts or gross profit.(16) The mark-up method can be expected to be used more frequently through the government's MSSP approach to audits as agents gain experience about the business operations of different industries.

If the taxpayer's books and records are not reflective of the taxpayer's overall economic profile/lifestyle, the agent must take into consideration an appropriate method for computing the taxpayer's income. Calculations based upon an indirect method must be corroborated with proper and competent evidence, including interviews with the taxpayer, records furnished by the taxpayer and third party sources. During Financial Status training, IRS agents have been reminded that fraud might be a factor.(17) Badges of fraud may include omissions of specific income, omissions of an entire source of income, personal expenditures and asset acquisitions in excess of reported income, a pattern of unreported income or overstated deductions over more than one year, concealment of a bank account, refusal to make certain records available, attempts to mislead the agent, admissions of unreported income or overstated deductions, maintenance of a double set of books, and repeated attempts to conclude the audit and pay any resulting liability. Much of the foregoing information is anticipated to be developed by the agents during interviews with the taxpayer and others.

Effective representation of a taxpayer facing a Financial Status audit requires extensive preparation. Questions posed to a taxpayer by an accountant might reveal improper activities on the part of the taxpayer that would not be protected by privilege. If the scope of inquiry by the accountant is limited to the return preparation, the accountant may not be adequately prepared for the audit. Alternatively, a more in-depth inquiry by the accountant may confirm unreported income or overstated deductions that could be discoverable by the government. As such,

accountants should strongly consider having the taxpayer interviewed by counsel prior to an audit in order to preserve potentially privileged information. In turn, retained counsel should consider engaging the accountant to coordinate the audit on behalf of the taxpayer. Under the doctrine of Untied States v. Kovel, 292 F.2nd. 918 (2nd Cir. 1961), the investigative accountant may be clothed with an extension of the attorney's privilege. Further, and of significant importance to the accountant, the accountant might become the subject of a malpractice action by the taxpayer if information revealed to the accountant during or in preparation for an audit is ultimately required to be divulged to the government. In order to preclude the accountant from becoming the primary witness on behalf of the government or a potential source of recovery on behalf of the taxpayer, it is imperative that counsel be engaged to interview the taxpayer as early as possible if there is any hint of improper reporting by the taxpayer. During the interview, all potentially sensitive aspects of the taxpayer's financial lifestyle should be thoroughly examined.

Certainly, an extensive indirect methods audit is not to be anticipated in every Financial Status audit. Although there may be plausible explanations for potentially sensitive issues that arise during the course of an audit, responsive statements by the taxpayer should not merely be repeated to the agent. Any potential explanation should be supported by credible evidence to avoid further inquiries arising from the explanation. A false or misleading statement to an agent during the course of an audit may be a badge of fraud. Depending upon the information developed in the audit, these Financial Status audits are expected to generate increased criminal tax investigations and prosecutions. As such, prior to the commencement of any audit, all relevant information must be closely scrutinized to determine plausible and supportable explanations for any potentially sensitive audit issues, whether or not such issues are set forth on the return. Financial Status audits represent a return to basic investigative audit techniques that can be expected to snare unwary "skillful" taxpayers.

1. The unofficial "27 Questions" are substantially:

a. Taxpayer's home phone number.

b. Taxpayer's work phone number.

c. Date of taxpayer's birth.

d. Confirm current year is on extension and provide a copy.

e. Was either spouse previously married?

(i) Paying or receiving alimony or child support? If so, how much and paid to whom?

f. Educational background of both spouses - highest level achieved - degree received, etc..

g. Previous occupations, employer and date.

h. Date of birth of children.

i. Purchase documents - application, closing documents, etc. for home. Who is mortgage holder? Payment?

j. What other real estate is owned and when was it acquired? Monthly rent? Does the taxpayer manage the real estate or have a management company?

k. Did the taxpayer make any improvements during the year to any of their real estate? What was done, how much did it cost and how was it paid for?

l. How many autos does the taxpayer own? What are they? What is the monthly payment? How were they paid for?

m. Does the taxpayer own any large assets (over $10,000) besides their auto and real estate? What is it, where is it kept? Is it paid for? If not, what is the payment?

n. Did the taxpayer sell any assets during the year under examination? If so, what, to whom and how much?

o. Did the taxpayer loan anyone any money during the year under examination? If so, who and how much?

p. Did the taxpayer receive repayments of any loaned money in the year under examination?

q. What loans did the taxpayer have besides auto and mortgage? How much? Monthly payment?

r. Did the taxpayer ever take a cash advance from credit cards or lines of credit? How much and how often?

s. What cash did the taxpayer have on hand during the year under examination usually, personally or for business, not in a bank - at home, safe deposit box, hidden somewhere, etc.?

t. What is the largest amount of cash the taxpayer had at any one time during the year under examination?

u. Did the taxpayer transfer funds between accounts? If so, how much and when?

v. Did the taxpayer ever redeposit funds previously withdrawn from their accounts?

w. Did the taxpayer deposit paychecks into the bank? What account?

x. Does the taxpayer have a safe deposit box? Where? What is kept in it?

y. Was the taxpayer involved in any cash transactions?

z. How long has the taxpayer's business been at its current location? Where was it previously?

aa. Employee business expenses - what meals are being deducted? Provide appointment calendar receipts, and identify the business purpose and business relationship for all expenses.

2. See Holland v. United States, 348 U.S. 121, 75 S. Ct. 127 (1954).

3. Holland v. U.S., supra; U.S. v. Tafoya, 757 F.2d 1522 (5th Cir. 1985) (bank deposits method associated with payments to an assassin); U.S. v. McGuire, 347 F.2d 99 (6th Cir.), cert. denied, 382 U.S. 826 (1965) (expenditures method).

4. Holland v. United States, 348 US 121, 75 S.Ct. 127 (1954).

5. Id. 75 S.Ct. at 135.

6. United States v. Johnson, 319 US 503, 517, 63 S.Ct. 1233, 1240.

7. Holland v. United States, 75 S.Ct. at 133-136.

8. I.R.M. [9781] 424.3 (1-18-80).

9. Lanier v. Commissioner 25 TCM 68 (1966); Blisset v. Commissioner 34 TCM 225 (1975); Reif v. Commissioner 33 TCM 133 (1974); Gaglione v. Commissioner 28 TCM 1024 (1969); Troncelliti v. Commissioner 30 TCM 297 (1971); and Schmidt v. Commissioner 33 TCM 379 (1974).

10. Harper v. Commissioner 54 TC 1121 (1970); Reaves v. Commissioner 31 TC 690 (1958); Roemer v. Commissioner 28 TC 1228 (1957); Doll v. Glen 231 F.2d 186 (6th Cir. 1956); Lockabey v. Commissioner 33 TCM 493 (1974); and Granat v. Commissioner 19 TCM 918 (1960), aff'd 298 F.2d 397 (2nd Cir. 1962).

11. Burke v. Commissioner, 929 F.2d 110 (2d Cir. 1991); U.S. v. Slutsky, 487 F.2d 832 (2d Cir. 1973).

12. U.S. v. Slutsky 487 F.2d 832 (2d Cir. 1973).

13. Gleckman v. U.S. 80 F.2d 394 (8th Cir. 1935), cert. denied, 297 U.S. 709 (1936); U.S. v. Tafoya, supra (payments for assassinations as the likely taxable source); but see Parks v. Commissioner, 94 T.C. 654 (1990).

14. U.S. v. Normile, 587 F.2d 784 (5th Cir. 1979); U.S. v. Slutsky, supra; Nicholas v. Commissioner, 70 T.C. 1057 (1978), Estate of Mason v. Commissioner, 64 T.C. 651, 653 (1975), aff'd, 566 F.2d 2 (6th Cir. 1977).

15. I.R.M. [9781] 427.12 (12-5-85), see also Conforte v. Commissioner, 692 F.2d 587 (9th Cir. 1982); Webb v. Commissioner 394 F.2d 366 (5th Cir. 1968); Edwards v. Commissioner 680 F.2d 1268 (9th Cir. 982).

16. Brodella v. U.S., 184 F.2d 823 (6th Cir. 1950); Jelaza v. U.S., 170 F.2d 202 (4th Cir. 1959), and Gnelino v. Commissioner 20 TCM 100 (1961) (gross receipts of a motel were reconstructed through average adjusted number of bedsheets used) and D & H Bagel Bakery, Inc. 14 TCM 334, TC Memo 1955-100 and Neptune Bagel Bakers, Inc. 14 TCM 339, TC Memo 1955-101 (number of bagels sold was determined by determining that 100 pounds of flour would yield 20 boxes each of which contained 56 bagels - adjustments were allowed for shrinkage and employee consumption in calculating the total gross sales of bagels).

17. Special Agents from the Criminal Investigation Division of the Internal Revenue Service participating in the Financial Status Training of Revenue Agents with the Examination Division.