FINANCIAL STATUS CHECK-UPS:

THE INTERNAL REVENUE SERVICE IS HERE TO HELP YOU!

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by

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The Internal Revenue Service has recently implemented its "financial status" or "economic reality" approach to its audit activities. Under this approach, a taxpayer's total financial situation is evaluated or profiled to ensure that the tax return accurately reflects reportable income. It is the common sense "smell test" approach to comparing information set forth on a return with the taxpayer's financial lifestyle or business activities. Financial status audits reflect an attempt by the Internal Revenue Service to increase compliance and to also search out potentially fraudulent situations. Under its Compliance 2000 Program, the Internal Revenue Service has attempted to identify and reduce non-compliance through legislative changes, tax form simplification, education, and enforcement. A primary goal of Compliance 2000 has been an effort to obtain a significant reduction in the "Tax Gap" - the amount of taxes due for a given year that are not voluntarily paid. For 1992, the Tax Gap was estimated at $105 billion for individual income taxes, $39 billion for employment taxes, and $33 billion for corporate income taxes representing a total estimated Tax Gap of $177 billion.

Under its Market Segment Specialization Program ("MSSP") the Internal Revenue Service focused on taxpayers as members of particular groups and formulated an approach to improve compliance based upon the unique characteristics of each group. These groups are defined by type of business (i.e. gas stations, grocery stores, etc.), technical issues (i.e. passive activity losses), type of taxpayer (returns lacking economical reality), or method of operation (i.e. cash businesses). Under this approach, examiners have become specialists in particular market segments and are now better able to reconcile discrepancies where the taxpayer's income and/or expenses set forth on their return might be inconsistent with the typical market segment profile or the standard of living prevalent in the geographical area where the taxpayer resides. As a result, the taxpayer's economic lifestyle has become a barometer for judging the taxpayer's returns.

Compliance studies performed by the now more specialized agents of the Internal Revenue Service discovered that in many situations net income reported on returns was insufficient to sustain the taxpayer's business operations, businesses reported continuous losses while staying in operation, reported profits were far below industry standards, and the lifestyles of many taxpayers did not match their return information. As a result, through the financial status audit approach the Internal Revenue Service will refocus its efforts an investigation, rather than mere verification of return information. In this regard, IRS representatives have subscribed to publications and trade journals, have joined trade associations, attend trade seminars, and have received training in order to specialize on particular market segments. These audits will focus on whether the taxpayer has sufficient income to support their lifestyle, standard of living and business operations, and expenditures and acquisitions.

Agents are instructed to determine if there is unreported income on a return based not only on the return itself, but also on information that can be deduced from what the Internal Revenue Service knows or can discover about the taxpayer. Much of this information can be obtained from interviewing the taxpayer and touring their place of business. However, substantial additional information will also be obtained from court records (divorce, probate, property records, mortgages, etc.), state information (licenses, permits, sales tax reports), trade associations, credit applications, reports submitted to financial institutions and otherwise, suppliers, trade associations, and personal contacts.

In addition to the foregoing, it can be anticipated that agents will explore various indirect methods of determining whether the taxpayer's return clearly reflects the reported income. These indirect methods include:

a) Net Worth Method - A method used to determine the increase between the taxpayer's assets and liabilities during the period under examination. Any unexplained increase is deemed attributable to current taxable income.

b) Expenditures Method - This method, also referred to as the "Source and Application of Funds" method, is concerned with the flow of cash for expenditures and the relationship of those expenditures to the source of funds. If a taxpayer's expenditures during a given year exceed reported income, and the source of funds is unexplained, the excess expenditures are deemed to represent unreported income.

c) Bank Deposits Method - Bank deposits are reviewed on the premise that deposits represent current taxable receipts. Expenditures and accumulations of currency are added to the deposits on the assumption that such amounts include current receipts that have not been deposited. Although it is a somewhat simple task to perform, a bank deposits analysis becomes more difficult as the unexplained deposits begin to accumulate or the account activity becomes excessive. A typical defense is that unexplained deposits are attributable to prior accumulated funds.

d) Mark-Up Method - The Mark-Up Method is based on the premise that there are certain percentages or ratios between sales, costs of sales, and net profit common to similar businesses in the same locality. Therefore, a taxpayer's profits may be determined by applying an acceptable industry-wide percentage to its gross sales, gross receipts or cost of goods sold. The resulting figure is then compared to the taxpayer's reported profit to determine if an understatement may have occurred.

Under the "financial status" approach, the Internal Revenue Service will analyze the taxpayer's financial lifestyle in an effort to attempt to determine unexplained asset accumulations or to reveal a standard of living that fails to have any reasonable relationship with the information set forth on the taxpayer's returns. As such, prior to the commencement of any audit, it is essential that a taxpayer's returns for the audit period be carefully reviewed. At a minimum, the taxpayer's financial and brokerage account statements should be scrutinized for at least the period covered by the audit. It should be anticipated that relevant questions will have to be answered as to the taxpayer's standard of living and the nature of the business activities.

Generally, communications between a lawyer and a client are privileged. However, there is not an accountant-client privilege. 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 the inquiry is limited to the return preparation, the accountant may not be adequately prepared for the audit. Alternatively, more in-depth inquiries 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 return, retained counsel should consider engaging the accountant to coordinate the audit on behalf of the taxpayer. In such event, the investigative accountant may be clothed with an extension of the attorney's privilege. Further, without the involvement of counsel, 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 a 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.