INDIRECT METHODS OF PROVING INCOME

IRM 4.10.4

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LESSON OBJECTIVES

• DEVELOP AN UNDERSTANDING OF THE CONCEPTS OF INDIRECT METHODS

• DISCUSS THE USES OF INDIRECT METHODS AND WHEN EACH IS MOST APPROPRIATE FOR USE

• CALCULATE A SIMPLE INDIRECT METHOD OF PROOF
MINIMUM INCOME PROBES

• Done on every audit
• You should perform one as well
• Consider Cash T/Source and Application of Funds
• Consider non-taxables
• When reconciling deposits for gross receipts reconcile 14 months
• Determine why excess funds exist
• Are funds co-mingled?
INDICATORS USED TO INITIATE AN INDIRECT METHOD OF PROVING INCOME

• BOOKS AND RECORDS DON’T RECONCILE TO THE RETURN OR THE BOOKS AND RECORDS DON’T EXIST
• EXCESS UNEXPLAINED DEPOSITS
• NO METHOD TO THE RETURN OR THE RECORDS OR THE METHOD USED DOES NOT REFLECT INCOME
• INADEQUATE INTERNAL CONTROLS
• CO-MINGLING OF FUNDS
• NO INCOME ON DEPOSIT
• USES CASH INSTEAD OF DEPOSITING – HOW DOES T/P KEEP TRACK?
INDICATORS (CONTINUED)

FINANCIAL ACTIVITIES DO NOT APPEAR IN BALANCE TO RETURN

GROSS PROFIT % CHANGES ON PRIOR AND SUBSEQUENT REVIEWS ARE INCONSISTENT
MATERIAL UNDERSTATEMENT

• DISCUSSION WITH MANAGER BY TECHNICIAN IS MANDATORY WHERE UNDERSTATEMENT IS $10,000 OR MORE

• Fraud considerations
INADEQUATE RECORDS LETTER

• EXISTS – ANOTHER DISCUSSION
IN DEPTH EXAM OF INCOME

RECOMMENDED WHEN:

• INCOME DOES NOT RECONCILE TO BOOKS/RECORDS
• UNEXPLAINED DEPOSITS
• LACK OF INTERNAL CONTROL
• INDICATION OF UNREPORTED INCOME (VS. A FIRM INDICATION OF UNREPORTED INCOME)

• NOTE AN IN DEPTH EXAM INCLUDES THE USE OF 3RD PARTIES (T/P
• SHOULDN'T BE GIVEN THE CHANCE TO VERIFY FIRST) another discussion
SPECIFIC ITEMS VS. INDIRECT METHODS

• SPECIFIC ITEMS AND DIRECT EVIDENCE IS PREFERRED OVER INDIRECT METHODS

• INDIRECT METHODS REQUIRE A LIKEY SOURCE OF CASH

• SPECIFIC ITEMS ARE NOT EASY TO IDENTIFY; FOR EXAMPLE, IN A GROCERY STORE
REMINDERS

• WHEN RECONCILING DEPOSITS TAKE OUT NON-TAXABLES, TRANSFERS, LOANS, GIFTS, INHERITANCES – BE READY TO VERIFY ITEMS

• REMEMBER CASH HOARD
TYPES OF INDIRECT METHODS

• SOURCE AND APPLICATION OF FUNDS METHODS

• BANK DEPOSITS AND CASH EXPENDITURES METHODS

• MARKUP METHOD

• UNIT AND VOLUME METHOD

• NET WORTH METHOD
IRC 446(b)

• Neither the Code or Regulations define or specifically authorize use of indirect methods.

IRC 446(b) PROVIDES THAT IF NO METHOD OF ACCOUNTING HAS BEEN REGULARLY USED BY THE TAXPAYER OR IF THE METHOD USED DOES NOT CLEARLY REFLECT INCOME, THE COMPUTATION OF TAXABLE INCOME SHALL BE MADE AS, IN THE OPINION OF THE SECRETARY, DOES CLEARLY REFLECT INCOME.
BURDEN OF PROOF IN UNREPORTED INCOME CASE

• SERVICE HAS THE BURDEN TO PROVE ITS CASE.

• LOOK FOR ERRORS SUCH AS DUPLICATIONS

• WAS CASH HOARD CONSIDERED?
FINANCIAL STATUS
AUDIT TECHNIQUES

• PER IRC 7602(e) IRS CAN’T USE “FINANCIAL STATUS AUDIT
TECHNIQUES” UNLESS THERE IS A REASONABLE INDICATION THAT
THERE IS UNREPORTED INCOME
STATEMENT OF ANNUAL ESTIMATED PERSONAL AND FAMILY EXPENSES

• CAPTURES PERSONAL LIVING EXPENSES

• TAXPAYER TO PROVIDE INFORMATION REGARDING EXPENSES

• BLS BUREAU OF LABOR STATISTICS CAN BE ACCESSED AT

www.bls.gov
CASE LAW FOR USING STATISTICAL DATA

• MILLER V COMMISSIONER

• PORTILLO V COMMISSIONER

• SENTER V. COMMISSIONER
SELECT PROPER METHOD TO USE

• WHEN INCOME IS NOT DEPOSITED, A BANK DEPOSIT ANALYSIS IS NOT APPROPRIATE

• WHEN CASH OUTLAYS CANNOT BE DETERMINED SOURCE AND APPLICATION OF FUNDS MAY NOT BE THE PREFERRED METHOD
SOURCE AND APPLICATION OF FUNDS METHOD

• ANALYSIS OF CASH FLOWS

• COMPARISON OF ALL KNOWN EXPENDITURES TO ALL KNOWN RECEIPTS FOR THE PERIOD

• NET INCREASES AND DECREASES IN ASSETS AND LIABILITIES ARE CONSIDERED ALONG WITH NONDEDUCTIBLE EXPENDITURES AND NONTAXABLE INCOME

• EXCESS EXPENDITURES OVER INCOME IS THE ADJUSTMENT TO INCOME

• ADJUST FOR ACCRUALS
BANK DEPOSITS AND CASH EXPENDITURE METHOD

• DEPOSITS AS RECONCILED

• LESS NONTAXABLES

• PLUS CASH EXPENSES

• ADJUST FOR ACCRUALS
IN CLOSING

• The material contained in this power point was prepared from consolidating and referencing the Internal Revenue Manual 4.10.4, the Internal Revenue Code and Audit Technique Guides.

• The practical applications, certain examples, and discussions are mine from experience and knowledge obtained over 35 years of working as a Revenue Agent, Group Manager, and finally Territory Manager at the IRS.

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