INDIRECT METHODS OF PROOF COMMONLY USED BY THE IRS

The IRS can use direct and/or indirect methods of proof to substantiate their claim the taxpayer has not reported and accurate amount of income. The ability of the IRS to use indirect methods of proof underscores the broad powers Congress and the Courts have given the IRS to determine a fair estimate of income when the taxpayer claims no records or the records that do exist are incomplete.

In the United States, the Supreme Court stated "…to protect the 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 taxpayer's books and records accurately reflect his financial history…" and it further noted that the indirect method used need not be exact, but must be reasonable in the light of the surrounding facts and circumstances.[1] The estimation may seem like guesswork and yet to be lawful it cannot be simply plucked out to the air. [2]Therefore, the judgement of the taxpayer's income must be based on some reasonable grounds. To provide a sound basis for assessment and defend court challenges, tax administrations have adopted the formal methods described below which have a that is tional foundation and cannot be described as arbitrary. That is not to say these are the only methods, but the discussion below will focus on the most commonly used methods of proof used the Internal Revenue Service to determine a reasonable amount of taxable income.

The Court decisions have in effect developed conditions which include:

May use any method to reconstruct income that is reasonable under the circumstances;

May not be arbitrary in the use of this authority;

May use an indirect method to test the accuracy of the taxpayer's books & records;

Must investigate all reasonable evidence presented by the taxpayer refuting the computation of income;

Determinations are presented to be correct and the taxpayer bears the burden of proving that it is incorrect;

i not required to negate every possible non-taxable source for the unreported income in order to sustain a deficiency based on a reconstruction of income; and

May use third party records (customers, suppliers, etc.) in the reconstruction.

Finally, taxpayer's can challenge the credibility of an indirect method by establishing a more reliable method of calculation or show that undeclared income was not from a taxable source.

This paper does note attempt to provide detailed discussion in the application of indirect methods, however further guidance in the use of common indirect methods together with

1 Holland v United States 348 US 121 (1954)

2 Briggs v Commissioner Internal Revenue TCM 2016-86

examples of computation, is available in the IRS Internal Revenue Manual[3] through the IRS public website.[4]

Bank Deposits & Cash Expenditures Method

This method of proof is based on the premise that money received must be either deposited or spent. This approach can be effective when an analysis of bank accounts and a taxpayer's cash expenditures indicate a likelihood of unreported income and the taxpayer regularly makes payments into bank accounts that appear to be from a taxable source.

A detailed analysis of all bank deposits into business and personal accounts, loan accounts, and accounts held with credit unions, investment trusts, and other financial institutions, that may be maintained or controlled by the taxpayer, provides the auditor with an amount for total deposits. Non-taxable receipts such as: loans, gifts, inheritances, are then deducted where the taxpayer is able to provide evidence of such receipts, giving the IRS auditor a net receipts deposited amount.

FORMULA FOR USING BANK DEPOSITS & CASH EXPENDITURES METHOD
Total Bank Deposits Including Business & Personal Accounts
Add: Cash Expdenitures (payments for business, capital & private expenditures)
Add: Increase in Cash on Hand
Less: Decrease in Cash or Hand
Less: Non-taxable receipts (VAT or sales tax)
Less: Interbank transfers
Less: Repayment of Loans
Equals: Gross Receipts as corrected
Less: Gross receipts per declaration

3 Internal Revnue Manual – Formal Indirect Methods of Determining Income Chapter 4.10.4.6

4 www.irs.gov/irm/part4/irm

Unreported Income

To establish receipts that were not deposited, cash expenditures need to be accounted for business expenses claimed in the declaration but not paid out of bank accounts are taken to have been paid by cash. Cash purchases of capital items and cash loan repayments both personal and business, personal expenses paid with cash and increases in cash on hand need to be determined through a thorough analyses of the taxpayer's financial affairs. Any non-taxable cash (e.g., loans withdrawals from accounts, or gifts that are used to make the above payments) where substantiated by the taxpayer are deducted to ascertain taxable gross receipts.

For taxpayers using the accrual method of accounting, the above computation of gross receipts is adjusted for changes in accounts receivable and accounts payable and then compared to the gross receipts reported by the taxpayer's declaration to calculate the amount of unreported income, if any. As expenses claimed in the declaration, but not paid out of the bank accounts, are included in cash payments, an adjustment will represent overstatement of deductible expenses or understatement of income.

The burden of proof rests with the taxpayer to prove that receipts came from non-taxable sources and therefore the taxpayer must be engaged in this process. The methodology premise demands income must be either deposited or spent, and therefore the accurate execution of this methodology provides a strong case for adjusting or establishing the veracity of declared income. Refer to Bacon v. Commissioner of Internal Revenue 80 TCM 219, TC Memo 2000-257 for a more detailed discussion of this method.

Source and Application of Funds Method (T-Account Method)

This method is also known as the Excess Expenditure Method or Funds Statement. It is based on the theory that if expenditure exceeds declared income plus income from unreported sources in a given tax period, that excess expenditure represents undeclared income from taxable sources. That is, funds applied cannot exceed funds available unless there are undisclosed sources of income.

This method requires a detailed analysis of all funds (taxable and non-taxable) available to a taxpayer all expenditures (business deductible and non-deductible and private) increased and decreases in assets and liabilities and adjustments to account for deductions not involving application of funds (e.g., deprecation expense) it is a favored approach when it is clear that the taxpayer's declared income could not sustain the evident wealth expenditure or lifestyle of the taxpayer. This method was employed to convict Al Capone of tax evasion in 1931.

Capone engaged in a wide variety of criminal activities – bootlegging, running numbers, prostitution, extortion and others as well. At its peak, Capone's criminal empire was worth approximately $1.3 billion when adjusted for inflation. Capone managed to evade authorities for his many crimes for a surprising length of time. That was partly due to his practice of bribing policemen, judges, public officials and others who had the capacity to bring him to justice. Federal authorities, including President Herbert Hoover, made it their mission to end the corruption and imprison Capone. In 1931, Capone was successfully prosecuted for multiple counts of tax evasion.

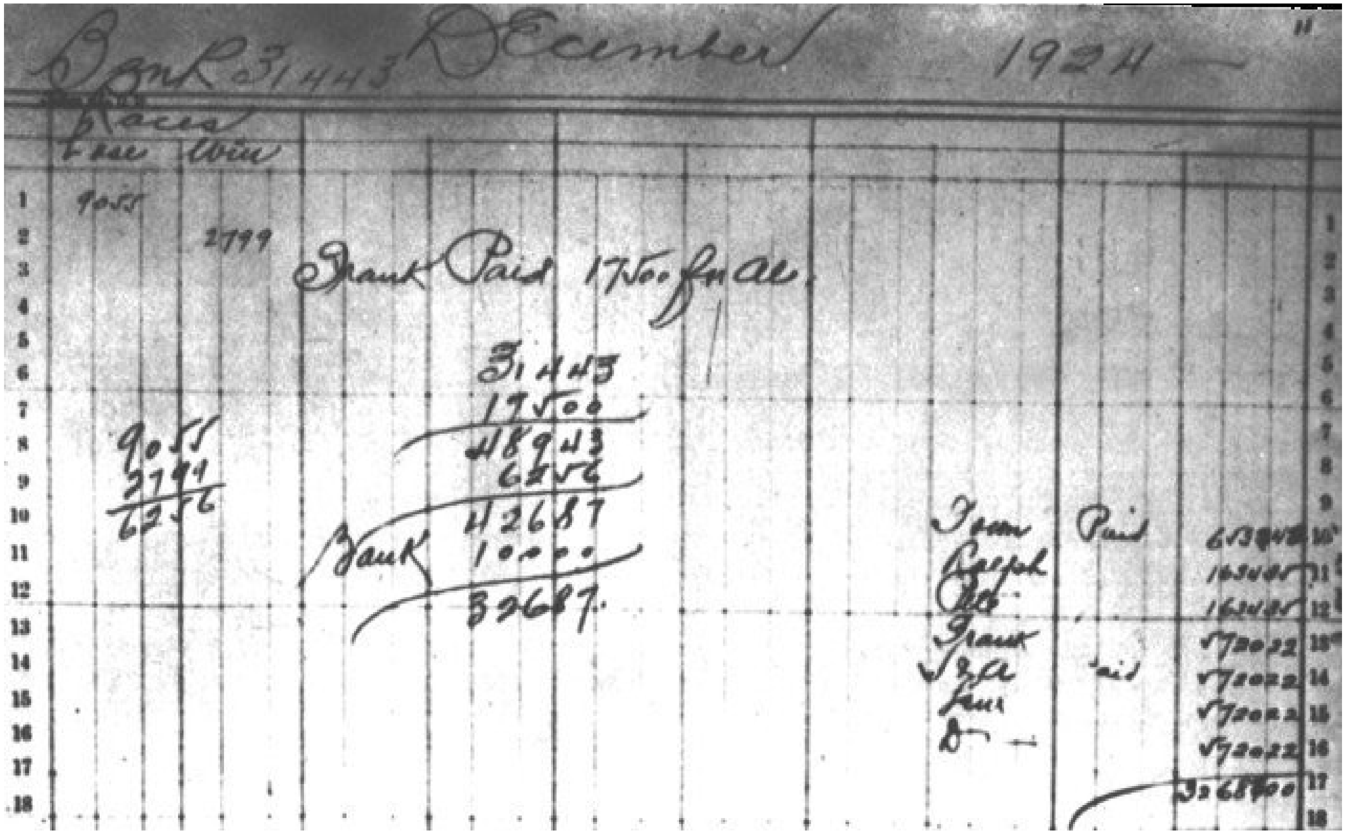
Prosecutors knew that it would be extremely difficult to produce witnesses who would testify against him in court, and so at first Capone was offered a relatively light sentence (of 2 years) in exchange for a guilty plea. The presiding judge in the case, though, was determined to put Capone away for longer, so he disallowed the lenient plea bargain.

Fortunately for the prosecution, testimony from numerous witnesses showed that Capone was the de facto owner of a highly profitable smoke shop. Witnesses said that Capone had been earning large sums of money from the shop for many years. Other witnesses also testified about Capone's wild spending habits. Considered as a whole, these factors created enough circumstantial evidence to demonstrate that Capone was in fact guilty of tax evasion.

In addition to an eventual 11 year prison sentence, Capone wound up being held liable for $215,000 in back taxes, as well as $50,000 in fines. He was also ordered to pay all court costs. The penalties were the largest ever for a tax evasion case up to that time. We have included below an exhibit from the Capone trial demonstrating the expenditures well in excess of income Capone reported and an excerpt of a general ledger showing Capone received income from these illegal activities.

INTERNAL REVENUE SERVICE - INTELLIGENCE DIVISION, CHICAGO, ILLINOIS
UNITED STATES v. ALPHONSE CAPONE

ITEM DESCRIPTION	1924	1925	1926	1927	1928	1929
BIRTHDAY PARTY	$ 3,350.00	$ 4,750.00	$ 1,975.00	$ 2,469.00	$ 2,921.00	$ 1,158.00
CABIN CRUISER, ETC.	0.00	32,000.00	0.00	16,000.00	264.00	0.00
CARS	5,300.00	3,500.00	0.00	0.00	5,380.75	6,640.00
CATERING FOR DEMPSEY/ TUNNEY FIGHT	0.00	0.00	3,450.00	0.00	0.00	0.00
CHINESE RUGS & OTHER FLOORING	3.400.00	2.775.00	3,975.00	3,896.97	859.07	1.499.00
CHRISTMAS PARTY	7,550.00	6.950.00	8.180.00	6.975.00	5.066.00	0.00
CHURCH CONTRIBUTIONS	5,200.00	7,800.00	10,400.00	15,600.00	5,430.00	0.00
COLUMBUS PARTY	2,000.00	2.925.00	3,160.00	2,633.00	2,262.00	0.00
CUSTOM SHIRTS	1,250.89	1,624.98	975.00	869.00	175.00	1,300.00
CUSTOM SUITS	5,500.00	6,180.00	2,180.00	2,835.00	1,080.00	4,080.00
DECK, BOATHOUSE, GARAGE--FLORIDA	0.00	0.00	0.00	0.00	0.00	17,450.00
DIAMOND BELT BUCKLES	0.00	0.00	0.00	8,250.00	0.00	0.00
DOCK	0.00	0.00	0.00	0.00	0.00	550.00
ENTERTAINMENT	0.00	0.00	5,502.00	31,455.00	1,398.00	0.00
FUEL	0.00	5,365.00	4,875.00	7,395.00	3,156.00	2,765.00
FURNITURE, ETC.	13,750.00	21,550.00	6.930.00	4.402.75	7.774.85	3,250.00
HOME-PALM ISLAND, FLORIDA	0.00	0.00	0.00	0.00	10,000.00	10,000.00
HOTEL LEXINGTON	16,200.00	0.00	0.00	0.00	16,910.00	13,975.00
HOTEL METROPOLE	0.00	25,525.00	22,710.00	23,825.00	0.00	0.00
HUNTING EQUIPMENT	2,525.00	6,110.00	1,900.00	3,861.00	1,155.00	1,279.00
HUNTING TRIP	0.00	0.00	14,205.00	8,582.00	0.00	0.00
IRON GATE - FLORIDA	0.00	0.00	0.00	0.00	0.00	490.00
JEWELRY	0.00	0.00	8,275.00	0.00	6.387.84	3.456.00
KENTUCKY DERBY PARTY	3,200.00	6,190.00	4.925.00	5.147.00	3,923.00	1,689.00



Source of funds are represented by the taxpayers declared income and income from non-taxable sources which the taxpayer is able to substantiate (e.g. gifts & inheritance) decreases in assets (e.g., bank account balance or accounts receivable) and increases in liabilities (e.g., principal amount of loans or accounts payable).

Application of funds include increases in assets (business and personal) purchases, business expenses, personal living expenses and decrease in liabilities.

If income has been correctly declared and the taxpayer auditor has accurately reconstructed the taxpayer's financial affairs the T-account will balance, that is the source of funds will equal the application of funds. However, if the application of funds is more than the source of funds, it is concluded that the excess expenditure represents an understatement of income or overstatement of deductible expenses. Accordingly, if the taxpayer is unable to prove that income was derived from some non-taxable source the taxpayer's income is adjusted upward.

FORMULA FOR COMPUTING INCOME BY SOURCE & APPLICATION OF FUNDS	
APPLICATION OF FUNDS	
	Asset Increases
	Liablity Decreases
	Deductible Expenditure per Declaration
	Non-Deductible Expenditure
LESS	
SOURCE OF FUNDS	
	Asset Decreases
	Liablity Increases
	Non-taxable Income
	Declared Income
=	**Understatment of income or overtatement**
	of deductible expenditure

Net Worth Method (also known as the asset betterment or asset accretion method)

This assumes that increases in net assets, after adjustments for non-deductible expenditure and non-taxable income, represent taxable income. Fundamental to this method is the notion that funds applied or expended cannot exceed funds available. The analysis required is similar to that used in the source & application of funds method, however, it extends over a number of years to ascertain changes to net worth from one year to the next.

This method relies upon a thorough analysis of all assets liabilities expenditure (business & personal) and non-taxable sources of funds to reconstruct a taxpayer's financial affairs over a number of years. For this reason, it is commonly used in cases where the taxpayer is suspected to avoid tax and accumulate considerable assets or had substantial changes in net worth over some period of time. This method also applies to the Capone case mentioned above.

As the formula suggests, the taxpayer's net worth (total assets less total liabilities) is determined at the beginning and at the end of the taxable year. The difference between these two amounts will be the increase or decrease in net worth. Adjustments are then made for non-deductible and non-taxable items to arrive at taxable income. Declared taxable income is then compared with income compared to determine whether income was understated or if there was no declaration the calculation determines the amount of taxable income.

FORMULA FOR COMPUTING ICNOME BY THE NET WORTH METHOD

a	Assets less liabilities = net worth
b	Net worth at end of year
LESS	Net worth at beginning of year
=	Increase or Decrease in Net Worth
ADD	Nondeductible expenditure
LESS	Nontaxable Income
=	Aggregate annual income as corrected

Percentage Mark-Up Method To Determine Gross Receipts

The percentage mark-up method relies upon applying a dependable ratio to a known base figure to establish a taxpayer's gross receipts. The strength of this method depends on the reliability of the percentage figures in computations. Although, industry standards and references to similar businesses or situations may provide a good guide as to the mark-ups used, even if the taxpayer's accounts are incomplete, the analysis of subsidiary records will often provide a better indication of actual margins adopted in that taxpayer's businesses. For example, gross profit percentages may be determined by comparing purchase invoices to sales invoices, analyzing price lists, examination of inventory records, order books, shelf prices, and other similar data. If it can be proven that the taxpayer consistently applies the same margin, particularly applicable to retailers of a limited range of goods, it will be difficult for the taxpayer to contest computations based on this methodology.

Example of % Mark-Up Method			
Cost of Liquor		$200,000	
Cost of Beer		$150,000	
Cost of Food		$50,000	
Cost of Sales – Liquor (% of selling price)	33.333%		
Cost of Sales – Beer (% of selling price)	66.667%		
Cost of Sales – Food (% of selling price)	50.000%		
Sales of Liquor ($200,000 x 3)			$600,000
Sales of Beer ($150,000 x 3/2)			$225,000
Sales of Food ($50,000 x 2)			$100,000
Total Sales as Reported			$925,000
Total Sales Declared			(750,000)
Unreported Sales			$175,000

Unit and Volume Method

By applying price and profit figures to the known ascertainable volume of business done by the taxpayer one can verify gross receipts. This method is feasible when the auditor can ascertain the number of units sold handled by the taxpayer and also knows the price or profit charged per unit. The number of units or volume of business done by the taxpayer may be determined in certain circumstances from the taxpayer's books, as the records may be adequate to purchases or expenses, but only inadequate as to sales. In other cases the determination of units or volume handled may come from third party sources or subsidiary records.

Using analytical and investigative techniques and accessing subsidiary records an auditor will often be able to ascertain the number of units of production or volume of work performed that will allow an extrapolation of a sales figure. There may be a regulatory agency or government agency to which the taxpayer reports units of production or service or payroll figures. These may be instances where the royalty paid for leasing machinery is based upon units of production. A piecework system of wages for production workers might also give an accurate measure of units produced. Examination of subsidiary records and establishing the relationship between inputs and outputs. For example, number of glasses of liquor sold from one bottle or keg, amount of water used per wash in a commercial laundry, number of sheets laundered to the number of rooms occupied in a hotel per night, number of subscribers to a magazine, number of customers in an appointment book, or order books for component parts required to manufacture saleable products, total tonnage produced by acre and the total price per acre earned per acre. Applying these metrics will often enable a reasonable accurate estimate of gross sales.

The use of this method lends itself to those businesses in which only a few types of items are handled or there is little variation in the type of service performed. If the auditor can determine the volume of inputs or outputs handled by the taxpayer and can establish the price per unit or profit per unit, the method will provide a reasonable accurate estimate of taxpayer's income without the complexity of totally reconstructing the taxpayer's affairs. The method can be effectively used for determination of gross receipts in the calculation of both direct and indirect tax liabilities.

Example of Unit & Volume Method	
Price Per Ton of Fruit	$900
Farmed Acres	100
Tonage Produced Per Acre	5,000
Revenue Generated	$450,000,000
Revenue Declared	$300,000,000
Omitted Revenue	$150,000,000

Industry Benchmarks Business Standards and Profile

Industry benchmarks are used based on the principle that businesses of comparable size and type should have similar financial performance. However, as they represent averages of business operating performance for a group of taxpayers and may not reflect specific taxpayer circumstances, they will not always be considered sufficient evidence of an understatement of income in a judicial proceeding and therefore are not always included in listings of formal indirect methods. The IRS is statutorily required to maintain financial statement ratios and can be used to support or refute a proposed adjustment or deficiency.

By way of example we have included a summary of the IRS ratios for electrical contractors for the tax year 2013. Other similar data can be found using RMA Studies,

Electrical Contractors 238210
From IRS 2013 Returns
With net income

					Asset Range		
	Total	**1-500K**	**500K-1M**	**1M-5M**	**5M-10M**	**10M-25M**	**25M-50**
Number of Returns	41,622	29,402	2,449	2,735	649	303	(
Net Sales (000s)	84,686,807	18,454,778	4,997,208	15,917,669	13,660,914	11,251,451	5,459,7
Total Assets (000s)	33,357,593	3,229,340	1,726,345	5,607,141	4,649,282	4,571,067	2,108,2
Assets							
Cash & Equivalents	17.92%	33.94%	31.53%	22.96%	19.99%	17.81%	18.52
Net Trade Receivables	40.41%	17.76%	20.22%	47.28%	5	52.94%	55.63

					5.20%		
Inventories	2.51%	5.02%	8.11%	3.44%	2.38%	1.59%	0.71
Other Current Assets	9.84%	3.49%	3.25%	9.54%	8.17%	10.81%	12.72
Total Current Assets	70.68%	60.21%	63.10%	83.22%	85.73%	83.15%	87.57
Net Fixed Assets	14.16%	22.70%	18.62%	10.09%	10.47%	9.65%	5.78
Net Intangibles	8.47%	1.66%	7.68%	2.02%	0.35%	0.25%	0.05
Other Non-Current Assets	6.69%	15.43%	10.60%	4.66%	3.45%	6.95%	6.60
Total Assets	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00
Liabilities							
Short Term Notes Payable	4.02%	10.63%	5.05%	4.91%	4.23%	4.22%	3.92
Trade Payables	13.56%	5.19%	12.07%	15.59%	20.43%	16.84%	19.44

Other Current Liabilities	19.69%	9.39%	12.51%	18.78%	27.31%	24.57%	28.46
Total Current Liabilities	37.27%	25.21%	29.63%	39.28%	51.97%	45.63%	51.82
Long Term Debt	10.61%	30.98%	10.75%	9.48%	7.72%	7.78%	6.73
Other Non-Current Liabilities	3.59%	0.52%	2.00%	1.88%	0.59%	1.15%	4.70
Net Worth	48.53%	43.29%	57.61%	49.37%	39.71%	45.44%	36.75
Total Liabilities & Net Worth	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00
Income							
Net Sales	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00
Cost of Goods Sold	66.84%	45.92%	63.10%	68.61%	75.04%	75.12%	78.20
Gross Profit	33.16%	54.08%	36.90%	31.39%	24.96%	24.88%	21.80

Operating Expenses:							
Compensation of Officers	4.26%	8.36%	7.00%	3.85%	2.41%	2.60%	3.39
Repairs & Maintenance	0.35%	0.44%	0.91%	0.27%	0.23%	0.25%	0.21
Bad Debts	0.13%	0.09%	0.08%	0.21%	0.20%	0.16%	0.02
Rent Paid on Business Property	1.63%	1.95%	1.61%	1.72%	1.10%	1.53%	1.07
Charitable Contributions	0.02%	0.01%	0.02%	0.04%	0.01%	0.01%	0.03
Amortization	0.15%	0.06%	0.19%	0.10%	0.07%	0.02%	0.01
Total	**Zero**	**500K-1M**	**1M-5M**	**5M-10M**	**Asset Range 10M-25M**	**25M-50M**	**50M-100**
Depletion	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00
Advertising	0.19%	0.35%	0.33%	0.18%	0.08	0.11%	0.08

					%		
Def'd Comp (Pension, Prof Shr, etc.)	0.47%	0.24%	0.46%	0.41%	0.35%	0.49%	0.81
Employee Benefit Programs	2.84%	1.06%	3.20%	4.08%	3.07%	4.50%	4.33
Other Expenses	16.49%	30.45%	15.46%	13.66%	12.44%	9.61%	6.82
Total Operating Expenses	27.59%	44.01%	30.57%	25.32%	20.55%	20.09%	17.27
Operating Profit	5.56%	10.07%	6.33%	6.07%	4.41%	4.78%	4.53
Other Items:							
Other Revenue	1.83%	0.42%	0.21%	0.56%	0.36%	0.64%	0.28
Interest Paid	0.28%	0.34%	0.43%	0.22%	0.27%	0.20%	0.19
Net Loss on Non-Capital Assets	0.00%	0.00%	0.00%	0.01%	0.00%	0.00%	0.00
Net Other Items as Expense	-1.54%	-0.07%	0.23%	-0.33%	-0.09%	-0.44%	-0.09
Earnings Before Taxes (EBT)	7.11%	10.15%	6.10%	6.40%	4.51%	5.23%	4.62
Income Tax	0.00%	0.00%	0.00%	0.00%	0.0	0.00%	0.00

					0%		
Net Income	7.10%	10.15%	6.10%	6.40%	4.50%	5.23%	4.62
Analysis							
Current Ratio	1.90	2.39	2.13	2.12	1.65	1.82	1.
Quick Ratio	1.57	2.05	1.75	1.79	1.45	1.55	1.
Net Sales / Net Trade Receivables	6.28	32.18	14.32	6.00	5.32	4.65	4.
Cost of Goods Sold / Inventories	67.56	52.28	22.53	56.54	92.57	116.38	284.
Cost of Goods Sold / Payables	12.52	50.60	15.13	12.49	10.79	10.98	10.
Net Sales / Working Capital	7.60	16.33	8.65	6.46	8.70	6.56	7.
EBIT / Interest	26.17	30.62	15.09	29.62	17.84	27.55	25.
Net Fixed Assets / Tangible Net Worth	0.35	0.55	0.37	0.21	0.27	0.21	0.
Total Debt / Tangible Net Worth	1.28	1.36	0.85	1.07	1.53	1.21	1.
% EBT / Tangible Net Worth	45.05%	139.32%	35.36%	38.37%	33.66%	28.47%	32.63
% EBT / Total Assets	18.05%	58.00%	17.66%	18.17%	13.25	12.87%	11.97

					%		
Net Sales / Net Fixed Assets	17.93	25.18	15.55	28.13	28.07	25.51	44.8
Net Sales / Total Assets	2.54	5.71	2.89	2.84	2.94	2.46	2.5
% Non-Cash Expenses / Net Sales	1.22%	1.05%	1.49%	0.90%	0.65%	0.82%	0.51
% Compensation / Net Sales	4.26%	8.36%	7.00%	3.85%	2.41%	2.60%	3.39

Using the benchmarks will at the very least assist the auditor in planning the audit and determining whether the taxpayer's figures are reasonable or whether there is a need to undertake further work to establish evidence of understatements.

Leads from 3rd Parties

Financial institutions, government agencies, stock exchanges and brokers, trade suppliers, real estate agents, and sales agents, can provide a wealth of information that may indicate tax evasion, assist in the computation of undeclared income by using the above indirect methods, or may provide evidence of amounts of undisclosed income. Increasingly, administrators are automating their interactions with such institutions, automatically capturing such information and matching the data with taxpayer declarations. This practice also provides auditors with ready access to relevant information through internal databases rather than having to undertake time consuming external searches.