

# Cash Intensive Businesses Audit Techniques Guide - Chapter 9 - Bail Bonds

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**Contents**

Bail Bond Defined ..... 2

State Control ..... 2

Transacting Bail ..... 3

Surety Contracts..... 3

Subagents ..... 4

Books and Records ..... 5

Terminology..... 6

Internal Sources of Information ..... 7

Third Party Sources..... 8

Initial Interview..... 8

Required Filing Checks..... 9

Primary Audit Issues and Techniques..... 9

    Gross Income ..... 9

    Income from BUF Accounts ..... 10

    Premium Income ..... 10

    Reimbursed Expenses ..... 11

    Collateral..... 11

    BUF Payment Deductions..... 12

    Tax Treatment of Bond Costs ..... 13

    Change in Accounting Method ..... 13

    Establishing Fraud ..... 15

## Bail Bond Defined

A bail bond agent is a person or business that arranges for the release of a person arrested or accused of committing a crime. This could include a release by means of cash or other property that is acceptable to the court in lieu of bail. The fee charged a defendant by a bail bond agent is usually 10% or more of the total bail amount required by the court.

This audit guide is concerned specifically with bail agents transacting bail on behalf of an insurance company. Licensed bail agents represent surety, or insurance, companies, which issue bail bonds. This type of bail bond is a contract wherein the insurance or surety company, which is ultimately liable on the full amount of the bond, contracts with a bail agent, who promises to indemnify the insurance company for forfeitures and related costs on bonds written by him or her if the defendant fails to make any scheduled court-ordered appearances. The bail agent has a prescribed period to surrender the defendant after a Notice of Forfeiture by the court. If the defendant does not appear, a Summary Judgment is issued and payment is due.

This industry tends to be cash intensive, since bail agents often prefer to collect cash rather than checks, due to the nature of their clients. Gross receipts are usually 50 percent to 80 percent cash.

Like many small businesses, there may be a lack of internal controls. The work force generally consists of the bail agent and perhaps one or two employees. This means that office functions such as writing bail, collecting fees, and depositing receipts may all be done by the same person.

The surety company provides a measure of control. It will track each bond by serial number and will require weekly reporting from the bail bond agent. Bail agents are required to account for every bond in their possession. However, the surety company does not control the actual collection of the premiums that the bail agents earn on each bond they write. The surety company also is not involved in any other cash collections, such as cash collateral or additional fees collected for travel, court costs, and long distance phone calls.

## State Control

In general, any individual who transacts bail for a fee in a given state must be licensed by the state's department of insurance. Various laws and regulations set forth requirements for licensing, record keeping, the collection of fees from and by the licensed bail agents, and maintenance of a build up fund (BUF) account with a surety insurance company.

The examiner must determine what type of bail licenses can be issued in the taxpayer's state. These may include:

- Bail Permittee -This license permits the licensee to solicit, negotiate, issue, and deliver bail bonds by posting his or her own funds with the court, as opposed to posting a bond through a surety company.
- Bail Agent -This license permits the licensee to act as the agent of a surety company, the contracts (bonds) of which are posted with the court, rather than actual cash or other

property. This is the most common kind of license. Most bail permittees are also licensed as bail agents.

- Bail Solicitor -This license permits the licensee to transact bail on behalf of, and as an employee of, either a bail agent or a bail permittee.

In order to understand the income and expenses generated in the bail bond business, it is advisable to have at least a limited understanding of the laws that bail agents must adhere to concerning fiduciary responsibilities involving the arrestee, record keeping requirements, and court procedures. The laws regulating this industry vary from state to state. Therefore, an examiner should be familiar with the laws of the state of the bail agent under examination.

There are often three separate sources of state laws which affect the operations of bail bond businesses. A state's insurance code might provide the qualifications and licensing requirements for bail licensees and a state's administrative code might provide definitions and regulations relating to bail operations. Because transacting bail is an integral part of the operations of a criminal court system, various aspects of the bail bond business can be defined in a state's penal code.

## **Transacting Bail**

After an arrest, the most common means of securing the release of the defendant is by means of posting a bond through a bail agent. The defendant, or one or more co-signors, signs a bail agreement with the bail agent which provides for reimbursement of expenses to the bail agent if the defendant fails to appear in court. These expenses include the full amount of the bond forfeited, reasonable expenses incurred by the bail agent to locate and surrender the defendant, and related court costs incurred.

Under this agreement, the bail agent collects a bail bond premium which he or she earns upon the release of the defendant. The premium amount is generally 10 percent of the face amount of the bond. From this premium collected, the bail agent makes two payments to the surety company, one for bond costs, and the other for his or her BUF account.

In addition to the bail bond premium, the bail agent may also collect collateral from the defendant, based upon his or her assessment of risks involved in the transaction. The collateral may be in the form of cash or other property, such as jewelry, cars, or deeds of trust.

## **Surety Contracts**

When a bail agent contracts with a surety company, he or she is contracting to write bail bonds for the surety company, as its agent. The surety company is ultimately liable for all bonds written by the bail agent on its behalf. The contract specifies premium rates, bond costs, and BUF payments, and contains an indemnity agreement. Other areas that are usually addressed include treatment of collateral, weekly reporting requirements, and terms for the return of the BUF account balance. The contract may also limit the amount of bail that the bail agent is permitted to write per bond.

The indemnity agreement usually specifies that the bail agent is responsible for any expenses relating to bonds written by the bail agent. These include the apprehension, movement, or surrender of the defendant, as well as any expenses relating to bond forfeitures.

The contract sets forth the terms regarding the blank bonds supplied by the surety company and the related bond costs. Blank bonds of various denominations are sent to the bail agent usually as replacements for previously executed bonds. Bond costs are expressed as a percentage of the face amount of the bond, with rates typically from 1.2 percent to 1.5 percent. Surety companies generally require strict accountability for each blank bond issued.

The surety contract also requires the bail agent to make payments into a reserve account, commonly called a build up fund, or BUF account. This fund is held in trust for the agent by the surety company in a separate account in a financial institution. The purpose of this BUF account is to provide funds to cover any potential liabilities incurred as a result of any forfeitures of bonds written by that specific agent. The bail agent usually has no access to these funds, and the surety company can make withdrawals from the account without permission from the agent. The BUF payment is based on a certain percentage, usually 1 percent, of the face amount of the bond as stipulated in the surety contract.

The surety contract will usually specify that, once it is terminated by either party, and all outstanding obligations have been satisfied, the remaining funds, along with accrued interest, will be returned to the bail agent. It may be several years after termination of the contract before all outstanding liabilities are satisfied.

The bail agent is usually required by contract to file a weekly report of bail transactions with the surety company. This report lists specific information on each bond written, the total premiums earned, and the related total liability (face amounts) of the bonds written for that period. The computed bond costs, BUF payment, and exonerated bonds are also listed.

## **Subagents**

A bail agent usually learns the bail business by on-the-job training, working for another bail agent. If the employee develops a good relationship with his or her employer and has a good grasp of the business, he or she may graduate to being a subagent of the former employer.

Under this relationship, the subagent becomes a sole proprietor, buying bonds from his or her former employer (now his or her general agent). This creates an additional layer of liability on the bonds written by the subagent because the general agent is also liable for all bonds written by his or her subagent. For this reason, the subagent will often pay into two BUF accounts, one through the surety company and one through his or her general agent. The subagent will pay bond costs to his or her general agent, in addition to the bond costs paid to his or her surety company. These additional bond costs are usually .3 percent to .5 percent of the bonds written by the subagent.

The reporting requirements will be the same, with the weekly reports generally going to the general agent before, or in addition to, the reports to the surety company. In this case, four checks will usually be submitted with the subagent's report, two for the BUF accounts and two for the bond costs.

## Books and Records

Certain books and records are specific to the bail industry. As the state laws indicate, the bail bondsman is required to provide copies of documents relating to a bail transaction to the defendant and must retain all pertinent documents at his or her place of business for 5 years beyond the completion of all parts of a bail transaction.

The following items reflect those books and records that are specific to the bail bond business:

**Numbered weekly reports to the surety company(ies) with which the bail agent is affiliated.** (Although most surety contracts require weekly reporting, these reports are often less frequently provided.) The information contained in these reports includes specifics on each bond written, including the serial number of the bond, the date the bond was written, the name of the defendant, the premium and the face amount of the bond. The totals reflected on the report include total liability (of all bonds), the total premiums earned, the total bond costs, and the BUF payment made.

**Canceled checks for bond costs and BUF payment.** Payments are submitted along with the weekly report and may be separate checks or a single check, depending on the surety company involved. The checks should indicate the related report number. If the agent is a subagent working through another agent, there should be one or two more checks -- one for bond costs to his or her general agent, and, if a local BUF account is required by the general agent, another check for the local BUF account.

**Bank statements/accounts.** There should be at least three business-related bank accounts: the BUF account maintained by each surety company with whom the agent is affiliated, the collateral account for all cash collateral received, and the operating account. There may also be a local BUF account as mentioned above.

**Income receipts.** The bail agent is required to provide a receipt for the premium received. This can be either from a separate receipt book or as part of the bond the surety company provides to the bail agent.

**Collateral receipts.** The agent may or may not write a separate receipt for collateral received, as required by state regulations.

**Invoices for blank bonds from the surety company.** All blank bonds sent from the surety company to the bail agent must be accounted for by the bail agent. The blank bonds, which are usually sent as replacements for bonds previously written, come in various denominations. For

instance, a \$15,000 bond can be used to write a bond for any amount up to \$15,000. The serial numbers and denominations for all bonds sent to the agent should be indicated on the invoice.

**Bail agreement.** This bail contract is between the defendant or a co-signor and the bail agent. State law will prescribe the items to be included in this contract. The most important items to the revenue agent are the premium received and the form and amount of collateral that may be collected.

**Surety contract.** This will list the contractual amounts of the premiums, requirements for the BUF account, and bond costs charged by the surety company. It will also name the general agent if the contract is for a subagent. The premium, BUF payment, and bond costs are usually expressed in percentages. The following figures are typical of surety contract terms:

- Premium earned 10% of face amount of bond
- BUF payment 1% of face amount of bond
- Bond costs 1.2% - 1.5% of face amount of bond

## Terminology

Due to the fact that bail transactions are an integral part of our court system, the terminology used in this industry includes legal terms as well as other terms specific to this industry. The following terms are commonly used in this industry:

**BUF Account.** This build up fund is the reserve account that is maintained by the surety company for the bail agent in order to cover any potential liability to the surety company for the bonds written by the agent. If the bail agent is a subagent for another agent, he or she may also pay into a local BUF account maintained by the other agent, his or her general agent.

**Exoneration.** "A bail bond is exonerated by appearance of the defendant to answer judgment of the court in conformity with terms of the bond." *Cain v. United States*, 148 F.2d 182 (9th Cir. 1945). Once a bond is exonerated, the bail agent and the surety company are relieved of any liability under the bond.

**Forfeiture.** The forfeiture of a bond is "a failure to perform the condition upon which the obligor was to be excused from the penalty in the bond." *Black's Law Dictionary* 778 (4th Ed. 1968). A forfeiture generally occurs when a defendant fails to make all court appearances as required by the terms of his or her bond.

**Penal amount.** This term is interchangeable with the full amount, the face amount, or the total liability of the bond.

**Premium.** This is the fee earned by the bail agent for writing a bond. It is usually equal to 10 percent of the face amount of the bond. This fee is earned once the defendant is released from jail.

**Posting fee.** When a bail bond is written for a defendant who is located in another county, the bail agent will pay a fee to a bail agent in the other county to post a bond for him or her.

**Skip tracer.** Otherwise known as a bounty hunter, this person is paid a fee by the bail agent to track down and retrieve a defendant who has skipped (i.e. left the area without appearing in court as promised). This is done to avoid having to pay a Summary Judgment, should the defendant not be located. Fees paid to a bounty hunter can be as much as 50 percent of the amount of the bond.

**Summary Judgment.** The court enters a Summary Judgment against a bail agent when the defendant fails to appear. For example, per section 1306 of the California Penal Code, a Summary Judgment is entered after the 180-day period has lapsed following the bond forfeiture. The bail agent is then liable for the full amount of the bond according to his or her surety contract.

## Internal Sources of Information

The Currency and Banking Retrieval System (CBRS) is used to track cash transactions over \$10,000. Since the bail bond business is cash intensive, the information from this system is particularly useful. The two forms that are most often encountered in this industry are the Form 4789, Currency Transaction Report, and the Form 8300, Report of Cash Payments Over \$10,000 Received in a Trade or Business. As discussed below, these forms serve slightly different purposes. The presence of one of these forms does not necessarily lead to a requirement that the other form be filed.

Form 4789 is filed by financial institutions when cash is withdrawn or deposited in amounts greater than \$10,000. This form identifies the depositor, the business for whom the deposit is made, the amount deposited, and into what bank account the funds are deposited. The amounts can be summarized and compared with the gross receipts per return and the business records presented during the audit. During the examination, these transactions can be compared with specific cash receipts per books to possibly identify income that is not deposited.

Form 8300 is filed by the bail agent when he or she receives cash in excess of \$10,000 in the course of his or her trade or business. Information on CBRS that a bail agent filed Forms 8300 is evidence that the bail agent has complied with IRC section 6050I. However, the examining agent should investigate the circumstances of cash deposits resulting in Form 4789 for the presence of exceptionally large bonds. It is customary in the industry for the bond premium to be 10 percent of the face amount of the bond. A bond with a face value of more than \$100,000 probably would generate a bond premium of more than \$10,000 for the bail agent. Thus, the bail agent might have been required to file a Form 8300 for that bond.

According to observations made so far in this industry, there are relatively few bonds written for more than \$100,000, the amount that indicates a potential requirement for filing a Form 8300. A bail agent's surety contract will often limit the bail agent from writing bail in excess of \$25,000 or \$50,000 without specific approval of the surety company. Most bonds are for \$3,000 to

\$20,000, earning the bail agent 10 percent of the bond amount. Hence, there may be a number of Forms 4789 generated due to these smaller bonds with a relatively few Forms 8300 required to be filed.

IRP transcripts can also be used to identify sources of income such as interest, dividends, rental income, and sales of stocks, bonds, and real estate. They can also be useful in identifying bank accounts and other investments.

## **Third Party Sources**

Information from a state's department of insurance can be useful in providing a general profile of the business before the examination has begun. Information such as the date the bail license was issued, the type of license, the number of employees in the business, and whether or not there are any partnerships involved can usually be provided. The department might also provide a list of surety companies that the agent has worked with and the dates involved.

If surety company information is obtained in the initial screening process for cases with audit potential, this information can be used during the pre-audit to compare income and expenses from the surety company information with income and expenses of the Schedule C filed by the taxpayer.

Surety companies can also be a source of additional information regarding income and expenses during the audit if the business records are inadequate. Timing differences between the surety company information and the business records should be resolved. Weekly bail agent reports, if available, are useful for this purpose.

## **Initial Interview**

The initial interview is a crucial step in the audit process. It is important to establish how involved the taxpayer is in daily operations, what books and records are generated, and what internal control measures are used, particularly in handling cash. Since this industry is cash intensive, questioning concerning cash should be thorough. Always ask who handles cash transactions, who deposits the cash, and how often deposits are made. Find out where cash is stored and how it is accounted for during the storage period. Ask follow-up questions to provide as much detail as possible.

Since unreported income is a common issue in this industry, and because bail agents often use bank deposits to determine gross receipts per return, it is important to determine from the bail agent if all cash receipts are deposited, if he or she pays any expenses with cash, and what bank accounts are used. Obviously, if bank accounts are used to determine gross receipts, any expenses (business or personal) paid by cash should be added to the total bank deposits to arrive at the correct gross receipts.

Since determining income is based on calculating premiums earned, it is crucial to establish in the initial interview as much detail as possible about uncollected accounts. This could include an

estimate of the average percentage of uncollected premiums per year and whether any year under examination varied from the norm. It should also be determined how the agent tracks outstanding accounts, what records are kept, and what collection measures are used.

Questioning should also include how collateral is handled and what form of collateral is taken, such as cash, personal property, or deeds of trust. It should be determined where cash collateral is deposited, whether any is deposited in the operating account before being transferred to the collateral account, and how it is handled on the books. Collateral receipts should be inspected, if available, to determine the disposition of the collateral. Ask if any collateral was seized or retained by the bail agent to cover outstanding bills or forfeitures.

Questioning regarding other sources of income or deposits, such as loan proceeds and sale of assets, should be thorough. If the taxpayer is using bank deposits to determine gross receipts for the return, the taxpayer should be asked what specific items are being deposited into his or her operating account or any other accounts used for his or her business. The taxpayer should also be questioned regarding what accounts are used for his or her personal expenses.

## **Required Filing Checks**

The areas that may require further investigation are employment taxes and information returns. Ascertain that all required returns are being filed. This includes checking Forms W-4 for accuracy, ensuring that information returns are being filed when appropriate, and that withholding returns are timely and accurate.

The initial interview should include questions regarding Form 8300 filing requirements. It should be determined if the taxpayer was aware of the filing requirements, and if so, when was he or she aware. If any Forms 8300 were filed during the years under examination, copies should be inspected. Income receipts should be inspected to determine if there were any cash transactions that would require the filing of a Form 8300.

## **Primary Audit Issues and Techniques**

### **Gross Income**

A thorough income probe is a crucial step in the audit process since unreported income is often an issue in this industry. The first step of the probe should be the initial interview with the taxpayer, with effective questioning directed at all possible sources of income, from the bail bond business and from unrelated sources. Questions should be tailored to address the specific facts and circumstances of each case.

Since books and records are often inadequate in this industry, indirect methods should be considered early in the examination to determine the reasonableness of income reported. Although many taxpayers in this industry use bank deposits to reflect gross receipts for a tax return, a bank deposit analysis should not be used as the primary indirect method, since often up to 80 percent of income received is in the form of cash. This fact, together with the lack of

internal controls that are often characteristic of this size and type of industry, may suggest that not all receipts are being deposited.

Bank statements must, however, be inspected since other sources of income can be discovered. Also, during the initial interview with the taxpayer, it should be determined how personal expenses are paid and what bank accounts are used, if any, for personal expenses.

## **Income from BUF Accounts**

A bail agent generally does not have access to funds deposited in his or her BUF accounts. However, the amount of restrictions placed on these BUF accounts may vary from case to case. Although most large surety companies place substantial restrictions on the BUF accounts, not all of them do. Also, general agents often set up local BUF accounts for their subagents with varying restrictions placed on them.

Therefore, each case should be evaluated to determine if substantial restrictions or limitations exist with respect to the BUF accounts involved. If it is determined that there are substantial restrictions or limitations on an account, then the bail agent does not constructively receive interest income from this account in the year in which it is credited to his or her account, see Treas. Reg. section 1.451-2(a).

However, an examiner should determine whether the proceeds of any of the restricted BUF accounts of a bail agent under examination were distributed by the surety company, either upon termination of the contract or in satisfaction of the bail agent's obligations to the surety company. In such an event, the bail agent might have received BUF account interest income in the year of distribution.

## **Premium Income**

The primary source of income in the bail bond business is premium income received from writing bonds. An indirect method of determining premiums earned can be used to test the reasonableness of gross receipts per return, and, when adequate books and records are lacking, this indirect method serves as a starting point for determining gross receipts for the examination. When adequate books and records are available, discrepancies between the taxpayer's books and surety company records should be reconciled.

Since most surety contracts require a BUF payment of 1 percent of the bonds written and premiums earned equal to 10 percent of the bonds written, premiums earned for the year can be calculated based upon the total of the BUF payments made for the year. For instance, if the total BUF payments are \$50,000, the premiums earned on the bonds would equal \$500,000. To arrive at cash basis income, the total premiums earned would have to be adjusted for any year end timing differences and any uncollected premiums.

Since the method of determining total premiums earned is relatively simple, the area of most concern is primarily in the determination of uncollected premiums and any timing differences in the collection of payments on account. This is an area where books and records are often lacking.

How the taxpayer tracks these outstanding bills, what collection procedures are used, and an approximation of the annual percentage of uncollected premiums should be determined during the initial interview. This should be followed up with an examination of whatever records the taxpayer has regarding these accounts receivable.

The weekly reports to the surety company provide a detailed listing of the bonds written for that reporting period. The amount of the bond and the premium earned are listed on a per bond basis along with the date the bond was written. This information is useful in determining the year end cutoff for income. The report will total the bond amounts and bond premiums, list the BUF payment amount, and list the exonerated bonds separately, usually at the bottom of the report.

Bond costs have not been used in this indirect method because some surety contracts have a \$5-\$10 per bond fee in addition to the percentage charge. This additional fee is usually passed on to the client.

## Reimbursed Expenses

Bail agents may collect fees from the defendant or his or her guarantor for expenses they incur in tracking and retrieving a defendant for court appearances. Defendants are usually charged for travel, long distance phone calls, and court costs. Since the bail agent expenses these out-of-pocket costs, any reimbursements of these costs must be included in income. This applies to any Summary Judgment paid by the bail agent for which the bail agent is subsequently reimbursed by, or on behalf of, the defendant. The bail agent typically is required by state law to retain a copy of these additional charges and to provide a copy to the defendant.

## Collateral

Collateral which is held by the bail agent must be returned upon request of the defendant once the bail is exonerated. However, any collateral returned may be reduced by any uncollected premium or by any other outstanding charges. Thus, the amount retained would be income to the bail agent.

If the bail agent receives collateral in lieu of all or part of the bond premium, then that portion of the collateral is not a refundable deposit, but rather is taxable income to the bail agent upon receipt. For example, if a defendant pays a 10 percent bail premium by paying 8 percent in cash and posting collateral in the amount of an additional 7 percent in either cash or property, the bail agent has received income in the amount of the full 10 percent bail premium. The additional 5 percent received is treated as a refundable deposit.

Not returning collateral is an area of potential abuse by bail agents. Accordingly, the bank statements for the collateral account should be inspected to determine if the bail agent is using the account properly. That is, whether cash collateral is deposited and returned on a timely basis. The only withdrawals should be for reimbursement of collateral. Any transfers into the operating account should be included in income since they are expense reimbursements.

A large beginning balance in the collateral account should be investigated further. There could be several explanations for the balance. Collateral may have been retained to offset unpaid expenses or forfeitures. In such a case, the collateral should have been transferred to the operating account and included in income.

Some collateral is simply never claimed after bail has been exonerated, and some collateral is related to bail that has not yet been exonerated.

Since collateral is returned only upon request of the defendant once he or she is exonerated, it can best be characterized as a refundable deposit. Although there are no specific court cases that have dealt with the collateral issue, case law relating to deposits indicates that deposits should not be included in income until the right to retain them is fixed. *Commissioner v. Indianapolis Power and Light Co.*, 493 U.S. 203 (1990); *Oak Industries v. Commissioner*, 96 T.C. 559 (1991).

In the bail bond industry, the only specific instance when a bail agent's right to retain collateral is fixed is when it is used to offset unpaid expenses associated with a specific bond. However, in the case of bail that has been exonerated, it can be argued that after a reasonable period of time, unclaimed cash collateral should be included in income.

If collateral in the bail agent's custody cannot be associated with specific bail bonds due to inadequate records, the revenue agent should take an initial position that the collateral should be included in income per IRC section 61. When cash collateral is commingled with operating funds, it takes on the same character and should be included in income, unless the taxpayer can substantiate the identity of the funds as cash collateral. If the taxpayer can establish the identity of the cash collateral, the collateral constitutes refundable deposits, irrespective of the fact that they are commingled with operating funds. See *Indianapolis Power and Light*, 493 U.S. 203; see also *Oak Industries*, 96 T.C. 559.

Property such as automobiles, jewelry, TV's, VCR's, and deeds of trust are commonly taken as collateral. Searches of Department of Motor Vehicle records and county property records may provide information on property collateral that has been retained by the bail agent. Unexplained deposits into the operating account may be the result of sales of property used as collateral. The depreciation schedule may also include collateral that was retained.

## **BUF Payment Deductions**

Payments made by bail agents into BUF accounts maintained by their surety companies are held as security for the agent's agreement to indemnify the surety company for any expenses incurred, including Summary Judgments, should the defendant fail to make court appearances as required by the bond. It has been observed that standard industry practice is to deduct these amounts when paid into the BUF account. Payments from this account for specific liabilities are often deducted as well, resulting in a double deduction for the taxpayer.

At least one state has a statutory requirement that surety companies maintain a BUF account for agents who represent them. Thus, payments into this account are necessary in order for bail agents to conduct business in that state.

The issue is whether transfers to this account are deductible when paid. Case law has long followed the course that payments made for future liabilities are not deductible. *Leslie W. Sebring & Nanci M. Sebring v. Commissioner*, 93 T.C. 220 (1989). In *Sebring*, the court held that the payments into the BUF account were deposits held as security for payment of contingent liabilities and were disallowed as deductions. Only payments from this account for specific liabilities were deductible.

The court in *Sebring*, *supra*, pointed out that, on termination of the contract between the surety company and the bail agent, the surety company was contractually required to return the balance of the agent's BUF account to the agent after satisfaction of all outstanding liabilities. Thus, the bail agent retains any benefits from the account plus earned interest.

Payments made by bail agents for their BUF account, therefore, are not deductible since they are not payments for specific liabilities. Bail agents are often required by their surety company to pay specific liabilities from their own funds. These payments would be deductible as they are made.

### **Tax Treatment of Bond Costs**

A bail agent pays a fee to the surety company which generally ranges from 1.2 to 1.5 percent of the face amount of the bond, or 12 to 15 percent of the bail premium earned by the bail agent. This fee represents the cost of the bond.

On a nationwide basis, the average life of a bond is 4 to 6 months, with 90 percent of all bonds falling within this category. However, the revenue agent should take the position that if the expected life of the bond exceeds 1 year, the associated bond costs are not currently deductible when paid, but must instead be amortized over the life of the bond. *Seaman v. Commissioner*, 84 T.C. 564, 587 (1985); *Treas. Reg. section 1.461-1(a)*.

Thus, for example, if a bail agent pays \$30 for a bond, which is not exonerated until the following year, the \$30 payment has created an asset (the bail agent's contractual rights under the bond) with an expected life of 2 years. Accordingly, the fee is deductible ratably over the 2-year life of the bond. Conversely, if the life of a bond does not extend substantially beyond the close of the taxable year, then a current deduction is appropriate. *Seaman*, 84 T.C. at 587.

The amounts paid by a bail agent to the surety company are similar to insurance payments made by automobile dealers in connection with extended service warranties. The Service has taken the position administratively that automobile dealers must amortize insurance payments over the life of an extended service warranty, even though the automobile dealer recognizes all of the income from the sale of the extended service warranty in the first year. See generally *Rev. Proc. 92-97*, 1992-2 C.B. 510. The same analysis can be applied to bail agents and the cost of bonds.

### **Change in Accounting Method**

When it has been determined that the taxpayer is currently deducting his or her BUF payments and he or she has a beginning balance in that account, a prior period adjustment per IRC section

481 must be made. The change from deducting payments into the BUF account to not deducting such payments (and only deducting payments from the BUF for specific liabilities) is a change in accounting method. Treas. Reg. section 1.446-1 states that "the term 'method of accounting' includes not only the overall method of accounting of the taxpayer but also the accounting treatment of any item". Treas. Reg. section 1.481-1 prescribes the rules to be followed in computing taxable income due to a change in method of accounting. "A change in method of accounting to which section 481 applies includes a change in the over-all method of accounting for gross income or deductions, or a change in the treatment of a material item.... In computing taxable income for the taxable year of the change, there shall be taken into account those adjustments which are determined to be necessary solely by reason of such change in order to prevent amounts from being duplicated or omitted."

Sometimes not only is there a deduction of payments into the BUF accounts, but also a deduction of any withdrawals from this account for specific liabilities. Thus, there is likelihood that deductions will be duplicated if the taxpayer deducts both payments into the BUF account and payments from the BUF account. If a bail agent is deducting payments into his or her BUF account, it must be assumed that prior years were treated the same, and, in order to account for this, the cumulative amount of previous deductions should be treated as a prior period adjustment per IRC section 481 and included in income to avoid a double benefit to the taxpayer.

The IRC section 481 adjustment is the total amount required to correct a taxpayer's cumulative overstatement of deductions, going back to the first taxable year in which the taxpayer deducted payments to BUF accounts. Consider the following example:

### **Example 1**

A taxpayer has been a bail agent for 10 years and cumulatively has paid \$100 into one or more BUF accounts during that period. The taxpayer deducted all of these payments currently. None of the \$100 paid into the BUF account was used to pay expenses or liabilities. The taxpayer has received a refund of \$60 due to the exoneration of some of the contracts. Therefore, the opening balance of the account is \$40. The taxpayer did not report the \$60 refund as income in the taxable year in which it was received. In this situation, the correct IRC section 481 adjustment is not \$40, but rather \$100 to reflect the cumulative amount deducted erroneously over the 10-year period.

The improper method of expensing the payments from the BUF account presents not only the potential for double deductions but also the potential for omitting income. *Graff Chevrolet Co. v. Campbell, Jr.*, 343 F.2d 568 (5th Cir. 1965) states that "when a taxpayer uses an accounting method which reflects an expense before it is proper to do so or which defers an item of income that should be reported currently, he has not succeeded (and does not purport to have succeeded) in permanently avoiding the reporting of any income; he has implicitly promised to report that income at a later date, when his accounting method, improper though it may be, would require it."

As this concept in *Graff Chevrolet*, supra, is applied to the BUF issue, the taxpayer, under his or her improper method of expensing the BUF payments when paid, would be required to include in

income any distribution made to him or her from his or her BUF account when the surety contract is terminated and all outstanding liabilities have been satisfied. This is likely to be overlooked. Since the surety companies hold these BUF accounts in trust for the bail agents as the property of the bail agents, they do not issue Forms 1099 to the bail agents when they distribute the BUF proceeds to them upon termination of the contract.

Even if a bail agent currently represents only one Surety Company, he or she may still have BUF balances through other surety companies due to his or her prior affiliation with those companies. In determining the amount which should be included in the prior period adjustment, the revenue agent should include not only the beginning balance of the current BUF account, but also any other BUF account balances which are still maintained by the bail agent's former surety companies.

## **Establishing Fraud**

### **Introduction**

To establish civil fraud, two facts must be proved: that the tax liability was understated; and that the understatement was due to deliberate intent to evade tax. To successfully establish fraud, one must look beyond the books and records and audit the taxpayer, not just his or her tax return.

### **Understatement of Tax**

Several aspects of the bail bond industry increase the likelihood that not all income will be reported by the taxpayer on his or her tax return. The cash intensive nature of the business increases the likelihood that not all cash receipts will be deposited. Collateral such as automobiles, TV's, VCR'S, and jewelry that are retained by the bail agent are not likely to be accounted for properly. Real estate seized to pay a Summary Judgment is another example.

Several indirect methods should be used to demonstrate that income was omitted from the tax return. The percentage method based upon BUF payments provides a reliable indication of reportable income once adjustments are made for timing differences and uncollected premiums. However, it does not address the application of those funds. Where did the money go?

Establishing how the unreported funds were applied gives additional credence to their existence. This can be accomplished by applying a second indirect method. IRM 4.10.4 discusses using the following methods: the Source and Application of Funds Method, the Net Worth Method, and the Bank Deposit and Cash Expenditures Method. Each of these methods would enable the examiner to identify the use of funds. Which method is used depends on the facts of each case as well as how comfortable an agent is with a particular method.

A thorough asset search is a critical step in the income probe. This is not only because it is a step in the analysis of the source and application of funds, but it may also turn up previously concealed assets, particularly since the retention of collateral is a potential source of income. A search of Department of Motor Vehicle Records may turn up vehicles that were used as collateral and retained by the bail agent. Acquisitions of real estate can be identified through county records. Verification of assets on the depreciation schedule may provide additional

evidence. A tour of the taxpayer's residence or place of business may turn up assets not previously accounted for by the taxpayer.

### **Fraudulent Intent**

The methods of establishing a taxpayer's intent to evade tax are no different for taxpayers in this industry than for any other taxpayers. A person's intent must be inferred from his or her actions - what he or she says and does. Therefore, it is crucial that the taxpayer's actions and interviews are well documented throughout the examination. Be alert for some of the more common "badges of fraud" that may be evidence of the taxpayer's intent to evade tax.

The existences of these "badges" do not alone prove fraud, but they may signify that additional steps should be taken to obtain "clear and convincing evidence." Every effort should be made to obtain direct evidence, such as false entries on books and records, or altered documents.

The understatement of income in itself does not imply intent to evade tax, particularly when books and records are poor. The understatement could be due to mistakes, a difference of opinion with regard to the proper treatment of a particular item, reliance on professional advice, carelessness, or negligence. If the taxpayer's accounting background is limited, there may simply be a lack of comprehension in terms of the tax treatment of certain items.

If books and records are so poor that they are likely to be responsible for the misstatement of income, an Inadequate Records Notice may be a more appropriate course of action than a fraud referral. Once the inadequate records have been so documented, the taxpayer has been put on notice of this deficiency. If he or she subsequently maintains poor books and records, this may be an indication that his or her intent is to evade tax. Thus a future fraud referral would be stronger.

Once an examiner determines that there is evidence of fraud, the manager and Fraud Technical Advisor should be consulted to ensure adequate evidence has been obtained before a fraud referral is made. The Fraud Technical Advisor can assist in determining whether a civil or criminal referral should be made.

If the taxpayer has failed to file Forms 8300 to report cash transactions, or filed incorrect or incomplete Forms 8300, he or she may be subject to civil penalties under IRC section 6721.