Cash Intensive Businesses Audit Techniques Guide - Chapter 6 - Evaluation Evidence of an Audit

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Techniques to Corroborate or Refute Income Related Items

Various audit and investigative techniques are available to corroborate or refute a taxpayer's claim about his or her business operations or nature of doing business. The following are illustrations of audit or investigative techniques for a cash intensive business:

An Examiner determines that a large understatement of income could exist based on return information and other sources of information that are in the case file. Interview questions are formulated based on the preliminary Cash-T information, and, at the initial interview, the taxpayer responds that no loans or gifts were received nor was a cash hoard maintained. No explanation was given for the difference in cash flows. After many repeated inquiries, the taxpayer responds that the amounts are from loans and gifts from relatives who live out of the country. (Remember that the taxpayer operates a cash business.) The books and records are poor. The taxpayer has no records to support the claim that the amounts are loans or gifts, except a copy of a letter from a relative stating that the relative gave the amounts at issue. (Sometimes the taxpayer's proof is only oral testimony.) The amounts at issue could be from unreported income from the cash intensive business.

How does an examiner corroborate the taxpayer's statements? How does an examiner refute it?

Evaluate the Initial Facts Concerning the Non-Taxable Sources and the Current Status of the Audit

- Ask the taxpayer for the specific dates and amounts of the currency received from friends or family – a vague and self serving letter from a friend or relative is not sufficient, the examiner will need to know exactly how much currency was received on each specific date.
- Was it US currency or foreign currency?
- Can the loan be verified by any other source?
- Can the lender show it was withdrawn from their bank on that date?
- Were FinCEN forms filed if currency was brought into the country?
- What day did the taxpayer get the money?
- How much did the taxpayer get on that day?
- What did the taxpayer do with the money that day? –the examiner can look for a cash influx in the bank or business that day. (A taxpayer didn't need to borrow money to keep it in a sock drawer for 3 months.)
- Ask for name, address, telephone number of each person providing cash loans. Inform the taxpayer that you will be contacting these individuals for proof, including requesting copies of their tax returns or other documents.
- How the foreign currency was converted to US currency?
- Where did the lender convert the currency?
- Now, ask for a copy of the exchange receipt issued by the bank or whomever exchanged the foreign currency for US currency
- If the lender converted the currency and brought it into the US, also ask for a copy of their passport showing entry to the US on that day

- If the taxpayer converted the currency, ask them to produce the exchange receipt.

The examiner must get specific information from the taxpayer. The taxpayer must have records of this, because if currency was received, the taxpayer will definitely know how much it was. If it is a loan, they will need to know what was borrowed so they can pay it back. They will need to know when it was borrowed to calculate interest. Even groups who use income pooling keep track of who has borrowed, what amounts are borrowed and when repayment is expected.

If the taxpayer cannot provide specific information the examiner should question the credibility of the statements. Real loans always have real records. This questioning should be intensive and will bring out inconsistencies if the cash loans do not exist.

Specific dates and amounts are important, because large cash expenditure in January can't be explained by a trip to a foreign country to obtain cash in March.

The examiner should consider issuing an IDR for this information.

If the taxpayer cannot provide specific amounts and dates of the currency received, they cannot know the understatement is not attributable to gross receipts.

If the taxpayer has sufficient detailed information, summonsing the loan makers or cash donors for an interview and additional documents would be appropriate. Also, summonsing bank records for the specific deposits would be appropriate.

When foreign currency is given by gift or loan, exchange rates can be found for the transfer dates. If they were not favorable, it is unlikely a friend or relative would have exchanged the currency at that time unless it was absolutely necessary. And, if it was absolutely necessary, the money would go into the bank or into the business immediately.

If this is a loan, ask to see how the taxpayer is paying it back. The loan will have occurred in the examination year, and by now, in the current year, the taxpayer should have paid some of it back. Ask to see how repayments are made. Ask how interest is calculated. If the taxpayer is repaying by taking currency to the foreign country, ask for the same type of specific information. Get exchange receipts and copies of their passport. Does the business show enough profit to be able to pay back loans on those dates?

In this case, a taxpayer may try to characterize an annual vacation as a trip to make a loan repayment. If only one payment is made during the year, it will necessarily be a larger than normal loan payment. Can withdrawals be found in the amount claimed to be paid back? Analyze the cash in and cash out for the week of the repayment.

Interview the family or friend lenders, if possible, and review their tax returns, if any are filed. Ask the same questions presented to the taxpayer:

- What are the specific dates and amounts provided to the taxpayer?
- Was it foreign or US currency?

- Who converted the currency to US? When? Where?
- What records do you have to prove this?
- What records do you have to guarantee the money will be repaid?
- Have any repayments been made? When? Where? How much?
- If not, why not?
- Ask to see copies of their passports to show they traveled into the country when they say they did.
- Ask to see copies of their bank withdrawals if money was withdrawn to lend to your taxpayer.
- Ask where the money came from.

It is possible that, when face to face with the examiner, the alleged lender will make statements inconsistent with the taxpayer's statements or give some evidence that they did not really have the ability to make these suggested loans.

Examiners are required to investigate all leads the taxpayer provides. If the taxpayer says he received money from someone, the examiner is required to investigate and explain if there are facts to corroborate the taxpayer's statements. It's up to the examiner to develop enough facts to show that this is believable or unbelievable.

Note: The Treasury Department requires anyone who transports, mails, ships or receives currency, traveler's checks, money orders or other negotiable instruments to be reported if the amount taken in or out of the US is over $10,000. You can request FinCEN Form 105 - Report of International Transportation of Currency or Monetary Instruments, from the taxpayer or the Bureau of Customs and Border Protection.

The techniques to corroborate or refute the taxpayer's claim could also be used when specific unexplained deposits are found through a bank deposit analysis.

Questions regarding the use of third party summons should be directed to your local Area Counsel.

Don't forget to research all the internal sources with information about money coming into the country.

Other Considerations

The examiner does not have to accept unsubstantiated and self serving statements as fact. The following considerations should be included when this type of testimony or evidence is evaluated:

1. Dates and amounts of transactions: Need to scrutinize individual deposits and determine their nature, that is, cash, check, wires, cashier or travelers' checks, or foreign currency. Is it possible?
2. Poor books and records indicate reduced credibility. A taxpayer with poor records usually cannot prove excess funds did not come from the business.

3. Identification and interview of donor/lender.
4. Cash hoard questions.
5. Money from foreign sources involved.
6. Evaluate standard of living of taxpayer and any lender of monies.
7. Results of bank deposit, Cash T, or source and application of funds.
8. Asset acquisitions: car/house/investments.
9. Taxpayer's detailed (or lack of) knowledge of lender/donor and transaction.
10. Have loan repayments been made? When? What amounts?
11. Is taxpayer's explanation questionable/credible, implausible or inconsistent?
12. Does taxpayer have a cash business? At what percentage of total sales in cash? Cash expenses?
13. Other areas to consider during audit:
    a. Uncooperative taxpayer/representative
    b. Procrastination
    c. Credibility
    d. Difficult/aggressive representatives
    e. Requests to issue 30/90 day letters at early stage.

Taxpayer

1. Obtain taxpayer's direct testimony on non-taxable source if not available through his/her representative:
    a. Taxpayer's relationship to lender/donor
    b. Lender/donor's source of funds/occupation/background
    c. Cash, check, and wire transfer
    d. If cash, how was it transported
    e. Does taxpayer have any business overseas?
    f. Cash hoard
        1. Who knew about it?
        2. Where was cash kept?
        3. Denominations
    g. Loan repayments, promissory notes
2. Can we obtain testimony under oath?
3. Issue summons?
4. Did the taxpayer continue to change testimony and what does this do to the credibility of the taxpayer's statement?

Taxpayer's personal and business records

1. The examiner should issue information document requests
2. If necessary the examiner should summons banks/brokerage firms/title companies early
    a. Find out what was really deposited
    b. Obtain copies of deposited items: checks, cash, traveler's checks, cashier's checks
    c. Check for unknown accounts especially through transfers
    d. Records of cash transactions [8300 reporting requirements]
    e. Wire transfer documents: identification of sender and country

f. In-depth analysis of bank deposits
g. Safe deposit box records
h. Purchases of travelers checks/money orders
i. Check for exchange of foreign currency
j. Obtain complete, legible copies of all-important documents.

3. Analyze acquisitions of real property, jewelry, business investments, and cars not commensurate with income.

These techniques may help discover additional facts that validate the taxpayer's statements. There can also be leads to unreported income, hidden foreign accounts and foreign earned income.

Specific Industry Applications of Audit Techniques

The following is just a few examples from the Examination Specialization & Technical Guidance's ES&TG Audit Technique Guides, showing how examiners can use creative skills in analyzing potential understatements and omissions of income in cash intensive businesses. Review the industry audit technique guides for additional suggestions.

NOTE: *Some methods require a third party contact.*

Industry/Omit Income	**Possible Audit/issues Techniques**
Retail Liquor Industry Off-book inventory—liquor sales	• Check for purchases outside of the liquor distributor, i.e. local wholesaler. • Bottle redemption • If needed, check with local/state beverage department for pending or completed investigations involving taxpayer and/or known suppliers of the taxpayer. • Check cashing
Cash purchases (suppliers—check for reporting income)	If necessary confirm method of payment for supplies by third party contact with suppliers. • Compare total payments by check to suppliers with total payments received by suppliers.
Video Games	• If necessary, contact vending machine companies to determine amount paid to business. • Watch out for sale/rental of bootlegged

Industry/Omit Income	Possible Audit/issues Techniques
	tapes/DVD’s
Preparation of cash deposits	Look for regularity of deposits and determine whether the taxpayer reconciles bank account. I internal control could be a concern.
Credit card sales—total omission v. partial omission	Observe whether the taxpayer has provisions for sales on credit card. Inspect bank statements and determine whether such transactions are recorded in the taxpayer’s books.
Pizza Pie sales	The difference of the number of boxes sold verse number of boxes used [minus some spoilage boxes] could be additional unreported sales.
Vendor allowances	Vendor agreements that should be treated as income to the taxpayer receiving the money or fixture (that is, sales fixtures put into the store without being paid for by taxpayer).
Bartering in the 21st century	• E-commerce – banner trading • Radio - free air time
New Auto Dealerships	Rebates - An automobile dealer must record the cost of new automobiles in inventory reduced by the amount of a manufacturer’s rebate, which represents a trade discount.
Gasoline Service Station	• Unit Mark up method used successfully – gallons of gasoline purchases times sales price = income. • Imaging Reimbursement • Incentive Agreements • Accommodations • Blending • Rebates
Auto Body Repair	• Income estimated by using Mitchell Guide [or similar guide] • Dollars per hour charge needs to confirmed • Insurance money is an income issues: dividends, refunds, claims, pre-paids and accruals

Industry/Omit Income	Possible Audit/issues Techniques
	• Unethical practices - Kickbacks (rentals), finders, referral fee.
Retail Gift Shops	Review books for lack of: • Advertising allowance • Gift certificate • Markdown participation • Layaway plan:
New Auto Dealerships	• Demonstrators are employee-employer issues • Extended Service Contracts • Hold back - Revenue Ruling 72-326
Used Auto Dealerships	Omitted income could include: • Fee Income • Rebate Income • Warranty Contracts • Consignments • Repossessed Vehicles
Restaurants & Bars	• Rebates to Franchisees from Suppliers • Compare restaurant Averages (sales v. cost) • 4% net profit • Low % spillage • Point of Sales machines and the Zapper program issue • Bar Averages (pour) can be used to calculate income • Fortune Cookie Analysis of sales for calculation of income
Grocery	Numerous sources for unreported income include: • Coupon processing rebate fees • Cash discounts from vendors • Rebates from vendors • Receipt of high dollar promotional items from

Industry/Omit Income	Possible Audit/issues Techniques
	vendors • Vending machines (i.e. newspaper) • Pinball machines/arcade games • Bottle/can redeeming • Money orders • Credit Card Sales • Food Stamp Sales • WIC Program Sales • Prepaid telephone cards
Boat & Yacht	One method for checking income is counting the number of steering wheels used. • Every boat has to have at least one. • Average sale price times steering wheels used equal potential gross income.

Special Focus Issues

Net Operating Loss and Passive Activity Loss Considerations

The net operating loss deduction (NOLD) is a relief provision Congress enacted to allow taxpayers to offset the losses against the profits of other years. This may result in a refund of income tax paid in prior years or a reduction in the amount of tax to be paid in future years.

A net operating loss (NOL) occurs when the expenses exceed the income of the business. The simple economics of an NOL are that during a loss year, there must be personal or other non-business funds to pay the losses, plus sufficient income to pay other personal living expenses. For example, if the taxpayer reports an NOL of $100,000 and has personal living expenses (mortgage, utilities, children, recreation, etc.) of $75,000, the taxpayer must have a source of $175,000 in funds that was used for these purposes.

Losses should generate additional questions about the taxpayer's business operations. For example, why is the taxpayer still in business if they have losses year after year? Why, even with losses, are they expanding products or locations? How are they able to pay expenses (cash flow)? And how are they able to secure loans for additional operating funds?

Important Item to Consider: If an examination of an open tax year identifies significant adjustments, which eliminate or greatly reduce a current year NOL, then any NOL carryforwards or carrybacks from other years should also be adjusted.

The courts have repeatedly held that the intervening year[1] taxable income that is subject to modification must be the taxpayer's correct taxable income, regardless of what was reported on the taxpayer's return. On that basis, they have held that where the taxable income of an intervening year was incorrectly reported on taxpayers return, it must be corrected for purposes of determining the amount of a net operating loss (NOL) which may be carried to another year, even though the intervening year is closed by the statute of limitations for all other purposes.

- Yellow Cab and Car Rental Co. of Gulfport, Miss., Inc. v. Commissioner, T.C. Memo 1974-79.
- Thomas E. Jr. & Lola v. Brock Medical Management Inc., T.C. Memo 1982-335.
- Robert J. and Doris M. Reilly T.C. Memo 1989-312
- ABKCO Industries Inc. 56-T.C. 1083 (1971), aff'd, 482 F. 2d 150 3rd Cir. 1973)
- Springfield Street Railway Co v. United States, 312 F. 2d 754, 63-1 U.S.T.C. 9189, 11 A.F.T.R. 2d 450.

[1]Any carryback or carryover year in which the NOL is not fully absorbed, is considered an "intervening year".

Examiners are encouraged to audit originating NOL tax years when they believe that taxable income may have been understated, even if the return is otherwise closed by statute. These examinations may significantly reduce or eliminate the NOL carryforwards into open examination tax years. Examiners should take caution, however, in commencing an examination of any open year[2] with a relatively short period remaining on the normal statute of limitations.

[2]*A year in which the normal statute of limitations for examination is not barred.*

A good technique for examining the NOL year, especially when records are unavailable, is an indirect method, such as a percentage markup (if cost of goods sold can be verified by third parties) or a fully developed Cash T (or source and application). There has to be a source of income, other than the business, to pay for the loss.

An analysis of the loss year and any years to which the loss was carried should be completed and included in the case workpapers. A spreadsheet is a good format for the analysis. The spreadsheet will begin with taxable income per return (or prior examination) and end with the proposed deficiency or overassessment. The analysis will insure proper accounting for all carryover and carryback items.

Passive losses may only be used to offset passive income. Passive losses are carried forward until they are offset against passive income or until the activity, which generated the passive loss, has been disposed. These losses usually do not become part of the taxpayer's NOLD until freed up by the taxpayer's sale of his entire interest in the activity. Examiners that have questions concerning PALs should contact their local PAL coordinator or the National Passive Loss Issue Specialist.

Employment Tax Issues

Employment tax returns of a business taxpayer are to be considered for examination at the same time the income tax return is examined. See IRM 4.10.5.5 for general guidance and the Employment Tax Handbook, IRM 104.6 for information on employment tax procedures and instructions for the preparation of examination reports. Examiners are also required to consider the issue of employee versus independent contractor.

IRM 4.10.5 (09-11-2007) - Required Fling Checks (RFC) are necessary to ensure voluntary compliance. Examiners should determine that taxpayers are in compliance with all Federal tax return filing requirements and that all returns reflect the substantially correct tax.

General Guidelines Required Filing Checks consist of the analysis of the return information and, when warranted, expansion of the examination to include additional returns. The following guidelines are applicable to all returns included within the scope if Required Filing Checks.

Filing Verification Examiners are to verify that all returns within the taxpayer's realm of influence have been filed. To decrease taxpayer burden, examiners should use internal sources of information whenever possible; for example, Corporate Files On Line (CFOL) and Midwest Automated Compliance System (MACS), to complete required filing checks.

Filing should be verified for prior and subsequent year returns, related returns, information returns, employment tax returns, gift tax returns, excise tax returns, pension plan returns, etc. IRM 4.10.5.2.1 (09-11-2007)

An estimate of expected wages/labor costs can be made by multiplying the number of hours a store is open times the prevailing minimum wage. If a retail store reports less than this amount, the examiner should question the taxpayer about other, unreported workers, or taxable fringe benefits offered in lieu of wages (removal of inventory).

Inadequate Records

All taxpayers are required by law to maintain accounting records of sufficient detail to enable the proper preparation of a tax return. If it is determined that the taxpayer has failed to maintain adequate records, then the issuance of an Inadequate Records Notice should be considered. This serves to place taxpayers on notice that their record keeping practices are deficient and must be improved to meet the requirements of the law.

Addressing poor record keeping practices is a significant component of case quality.

An Inadequate Records Notice should be considered for a cash intensive business whenever:

- an adjustment is made using an indirect method (the existing records did not accurately reflect income)
- an adjustment is made and source documents, such as cash register tapes, receipts or invoices, were missing

- an adjustment is made and no books were maintained an adjustment is made because the taxpayer failed to disclose a source of income (for example, internet sales or another business)

If an examiner finds that a taxpayer's books and records are inadequate, they will discuss the inadequacies with their manager. The examiner will also discuss the situation with the taxpayer and explain in detail what needs to be done to correct the problem. This must be documented in the examiners workpapers or case history. After completion of the examination, the examiner prepares letter 978 or 979 to notify the taxpayer. The contact for the letter is the PSP individual responsible for the program. The letter is signed by the examiner's manager and sent by certified mail to the taxpayer. A copy of the letter, case history and audit report go to PSP.

It is very likely the taxpayer will be examined in the future to determine if the recordkeeping practices have improved.

See IRM 4.10.4.4.2 (09-11-2007) for procedures to issue an inadequate records notice.

Proper Development of Cases

If, during the audit, the examiner discovers a discrepancy in income between that determined by an indirect method and that reported on the return, the examiner should not assume that the discrepancy is due to fraud. The discrepancy could be an error; it is often helpful to open a previous or subsequent year for examination to see if a pattern emerges.

If a satisfactory explanation exists, the examiner can save considerable examination time and unnecessary delays in the audit by first asking the taxpayer to explain the reason for the discrepancy.

Responsibility for the discrepancies or errors should be determined. If a false or evasive explanation is given, the facts and circumstances should be weighed against the elements of fraud.

Fraud Considerations

Taxpayers who knowingly understate their tax liability often leave evidence in the form of identifying earmarks (or indicators). Fraud indicators can consist of one or more acts of intentional wrongdoing on the part of the taxpayer with the specific purpose of evading tax. Fraud indicators may be divided into two categories: affirmative indications or affirmative acts. No fraud can be found in any case unless affirmative acts are present.

Affirmative indications serve as a sign or symptom, or signify that actions may have been done for the purpose of deceit, concealment or to make things seem other than what they are. Indications in and of themselves do not establish that a particular process was done; affirmative acts also need to be present. Examples of affirmative indications include:

- substantial unexplained increases in net worth,

- substantial excess of personal expenditures over available resources,
- bank deposits from unexplained sources substantially exceeding reported income
- inadequate books and records
- conduct that is evasive, misleading or uncooperative

Affirmative acts are those actions that establish that a particular process was deliberately done for the purpose of deceit, subterfuge, camouflage, concealment, some attempt to color or obscure events, or make things seem other than what they are. Examples include:

- omissions of specific items where similar items are included,
- concealment of bank accounts or other property,
- the use of nominees on bank accounts or other property
- failure to deposit receipts to business accounts
- hiding sources of receipts
- destruction of records

Fraud is generally defined as deception, misrepresentation of material facts, or silence when good faith requires expression.

Elements common to all tax fraud cases include an understatement of tax liability, willful intent to evade taxes and a course of action demonstrating the taxpayer's intent.

1. Presence of Fraud
   Fraud implies bad faith on the part of a taxpayer, shown by acts calculated to cheat, mislead, or conceal. This can include the destruction or concealment of records relating to an income source.
2. Elements of Fraud – The Government is required to prove:
   a. A significant understatement of tax liability.
   b. Willfulness – an act of commission, or omission, requiring:
      1. Knowledge – consider education, experience, and participation in the acts.
      2. Intent – implied from words and action of the taxpayer.
      3. Evil Purposes – A dishonest intent to conceal or misrepresent.
3. Consideration for the Agent
   a. Identify all bank accounts.
   b. Issue summons as needed.
   c. Ask taxpayer for explanation of understatement.
   d. Refute or verify the taxpayer's explanation.
   e. Expand the examination to multiple years or related entities.
   f. Consider the preparer's involvement.
   g. Contact third parties as needed.
   h. Identify a likely source of income.
   i. In an altered documents case, show that the expenses are fictitious.
   j. Show harm to the government
   k. Consider additional expenses that go along with unreported income.

If the examiner suspects a potentially fraudulent situation, either civil or criminal, they will discuss the case with their manager as soon as possible. If the group manager concurs, the fraud technical advisor (FTA) will immediately be contacted and both the group manager and FTA will provide guidance on how to proceed.

Cash Hoard

With a cash intensive business, it is important to get complete information about nontaxable income as soon as possible in the examination. Question the taxpayer about any Cash T imbalances during the initial interview. If there is a cash hoard, or other nontaxable income, the examiner will want to consider this information early in the examination. It will be necessary in every indirect method case.

Cash-on-hand should be established for the beginning of each year under audit. Also, the taxpayer’s practice of keeping cash on hand should be determined for present and prior periods to establish any accumulation of cash over the years. Cash- on- hand is defined as including all cash not in a financial institution, such as: at home, in pocket, in a safe deposit box or a safe.

A taxpayer’s explanation about a cash hoard may change during an examination. The examiner should document the information as it is received. The documentation should include when and where the information was received, who was present, what was said, and when the documentation was prepared.

The credibility of a cash hoard explanation should be examined. The examiner should ask to see the cash hoard and where it is kept to determine if the space is adequate. The examiner should examine the taxpayer’s bill paying and borrowing habits; an individual with a cash hoard will not incur insufficient funds charges for checks written or require loans.