

**Office of Chief Counsel
Internal Revenue Service
memorandum**

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to: Associate Area Counsel, Louisville
(Small Business/Self-Employed: Area 4)
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from: Peter K. Reilly, Special Counsel (Tax Practice & Procedure)
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subject: Economic Reality Examination
National Research Program

This Chief Counsel Advice responds to your request for advice dated November 4, 2002. In accordance with I.R.C. § 6110(k)(3), this advice should not be cited as precedent.

ISSUE

Do the provisions of section 7602(e) prevent a revenue agent from requesting in an initial interview letter the personal and business bank records from taxpayers who derive a substantial portion of their income from Schedule C and F income where the returns are randomly selected for the National Research Program (NRP)?

CONCLUSION

Section 7602(e) provides that the Service should not use an indirect method to determine the existence of unreported income of any taxpayer unless there is a reasonable indication that there is a likelihood of such unreported income. The invocation of section 7602(e) is premature at the time revenue agents request bank records and personal records through the initial contact letter since the Internal Revenue Service (Service) is not yet making a determination with respect to the existence of unreported income.

FACTS

As a result of the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA '98), Pub. L. No. 105-206, section 3412, 112 Stat. 685 (July 22, 1998), the NRP office was established in April 2000, as a component of the Research, Analysis, and Statistics

Division. The goal of the NRP office is to collect and analyze information that helps the Internal Revenue Service (Service) identify where and why compliance problems occur so that resource allocation and program development can be tailored and improved accordingly. The NRP is intended to be “far less intrusive and burdensome on taxpayers than previous compliance studies.” IRS News Release IR-2002-05 (Jan. 16, 2002).

As we understand it, returns that are a part of the NRP program are randomly selected for classification and potential audit rather than being identified by the Discriminant Function (DIF) formula or through some matching program. Thus, at the time of random selection there is no reason to question the information reported on these returns. During the initial classification process, information is gathered from internal databases and compared with data reported on the taxpayer’s return. Some of the “case building tools” used for the preliminary classification process include information from the Midwest Automated Compliance System (MACS), IDRS, INOLES, IMFOLT, the Business Master File On-Line (BMFOL), Payer Master File On-Line (PMFOL), Information Returns Data, Dependent Database, Dependent Database On-Line, Currency and Banking Retrieval System (CBRS), and ChoicePoint. IRM 4.22.2.2. Each one of those tools uses information already internally available to the Service. The goal of return classification is to select those returns for audit with the greatest potential for change. IRM 4.22.3.1(2).

As we understand it, when examining returns from taxpayers who derive a substantial portion of their income from Schedule C and F income, agents perform a preliminary cash-T analysis using tax return data and information gathered in the case file during the classification process to see if that information supports the income claimed.

As part of the initial interview process, agents request bank records and personal records regardless of whether the preliminary cash-T analysis indicates the information supports the income claimed. You are concerned with whether, in light of the enactment of section 7602(e), revenue agents are permitted to request this information in the initial interview letter where the preliminary analysis and case materials to date do not show a reasonable indication that there is a likelihood of unreported income.

LAW AND ANALYSIS

Section 7602(e)

RRA ‘98 also added new I.R.C. § 7602(e), entitled “Limitation on Financial Status Audit Techniques.” Section 7602(e) provides that “the Secretary shall not use financial status or economic reality examination techniques to determine the existence of unreported income of any taxpayer unless the Secretary has a reasonable indication that there is a likelihood of such unreported income.” The legislative history concerning RRA ‘98 section 3412 reflects that prior to its enactment, the Service could use financial status or economic reality audit techniques to determine the existence of unreported income. The legislative history states that RRA ‘98 section 3412 merely prohibits the use of such audit techniques to determine the existence of unreported income until the Service has a reasonable indication

that there is a likelihood of such unreported income. H. R. Conf. Rep. No. 105 -599, at 270 (1998).

Prior to the enactment of section 7602(e), the Chairman of the House Committee on Ways and Means requested that the General Accounting Office report on the frequency and results of the use of financial status audit techniques to identify unreported income, due to concerns over the treatment of, and the burdens placed upon, taxpayers. General Accounting Office Report GAO/G-GGD-97-186 (September 26, 1997), Tax Administration, Taxpayer Rights and Burdens During Audits of Their Tax Returns, at 3 and 9 (GAO Report). The term "Financial Status Audit Techniques" is not defined in the Code. As used in the GAO Report, financial status or economic reality audit techniques consist of indirect methods of examination such as the bank deposits method, the cash transaction method, the net worth method, the percentage of mark-up method, and the unit and volume method. GAO Report at 9; Examination of Books and Returns Handbook, I.R.M. 4.2.4.6. The General Accounting Office concluded that these techniques were never used alone and that they were used with other techniques that were used to explore issues other than unreported income, such as overstated deductions. GAO Report at 9.

Audit Techniques

There are two distinct types of methods of proof in tax cases, direct or specific item methods and indirect methods (financial status or economic reality examination techniques). In the direct or specific item methods, specific items are demonstrated as the source of unreported income. United States v. Hart, 70 F.3d 854, 860 n.8 (6th Cir. 1995); United States v. Black, 843 F.2d 1456 (D. C. Cir. 1988). With the specific item method of proof, the government uses "evidence of receipt of specific items of reportable income...that do not appear on his income tax return." United States v. Marabelles, 724 F.2d 1374, 1377 n.1 (9th Cir. 1984). For example, the Service tracks funds from known sources to deposits made to a taxpayer's bank accounts rather than analyzing bank deposits to identify unreported income from unknown sources. See United States v. Hart, 70 F. 3d 854, 860 (6th Cir. 1995) (tracing of unreported income from covert police funds is a direct method); United States v. Black, 843 F.2d 1456 (D. C. Cir. 1988) (monies traceable from dummy corporations to the taxpayer was evidence of specific items of income and not the use of the bank deposits or cash expenditures indirect method of proof). See also Pollack v. United States, 1998 U.S. Dist. LEXIS 16224 (N. D. Ill. 1998) (recognizing, in dicta, that directly tracing money transfers from an entity would not be a financial status or economic reality technique).

The Service does not use specific items to support an inference of unreported income from unidentified sources. The use of direct methods simply does not implicate the provisions of section 7602(e). Thus, there is no prohibition requiring the Service to have a reasonable indication that there is a likelihood of unreported income before resorting to direct methods.

When using an indirect method, a taxpayer's finances are reconstructed through circumstantial evidence. United States v. Hart, 70 F.3d 854, 860 n.8 (6th Cir. 1995). For

example, the government shows either through increases in net worth, increases in bank deposits, or the presence of cash expenditures, that the taxpayer's wealth grew during a tax year beyond what could be attributed to the taxpayer's reported income, thereby raising the inference of unreported income. United States v. Black, 843 F.2d 1456, 1458 (D. C. Cir. 1988). Indirect methods are used to support an inference of unreported income from unidentified sources.

The bank deposits indirect method is an analysis of bank deposits to prove unreported income from unidentified sources. This method, which computes income by showing what happened to the taxpayer's funds, may be considered to be a financial status technique when it is used without the specific knowledge of a possible traceable source. As such, it is used to supply leads to possible unreported income from sources of such deposits. Examination of Returns Handbook, IRM 4.2.4.6.3. With the cash transaction indirect method, the Service calculates the unreported income as the amount that the taxpayer's cash expenditures exceeded the taxpayer's sources of cash, including cash on hand at the beginning of the tax period in question, for the particular year. United States v. Hogan, 886 F.2d 1497, 1509 (7th Cir. 1989). The Service uses the taxpayer's tax return and other sources to ensure that adequate income has been reported to cover expenses. GAO Report at 9.

Pursuant to the IRM with respect to commencement of an examination, pre-contact analysis requires the agent to prepare a preliminary cash transaction account (cash-T) based upon tax return information and other information in the case file.

IRM 4.10.4.3.3.1(1). If the cash-T is materially out of balance, the examiner is guided to use subsequent interviews and information gathering during the examination to resolve those discrepancies. IRM 4.10.4.3.3.1(6).

During the examination phase for business returns, the IRM advises that the revenue agent should, among other things, analyze the personal and business bank records of the taxpayer.¹ IRM 4.10.4.3.3.4. The manual does not require that the request for bank records be made as part of the initial contact letter, but the review of the taxpayer's bank statements is considered in the manual to be a "minimum probe" of income. The manual provides that if the results of the minimum probe show the existence of potentially unreported income due to a significant imbalance in the cash-T, excess unexplained bank deposits, or inadequate internal controls, a more in depth examination is warranted.

Section 7602(e) provides that the Service should not use an indirect method to determine the existence of unreported income of any taxpayer unless there is a reasonable indication that there is a likelihood of such unreported income. The invocation of section 7602(e) is

¹ According to IRM 4.10.4.3.2 (1), minimum income probes of individual nonbusiness returns do not include preparation of a preliminary cash-T or a request for bank records. That section states that the questioning of the taxpayer and the completion of some workpapers will fulfill the minimum income probe requirement if there is no other information in the file indicating potential unreported income.

premature at the time revenue agents request bank records and personal records through the initial contact letter since the Service is not yet making a determination with respect to the existence of unreported income.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

None.

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Please call if you have any further questions.