



# MANUAL TRANSMITTAL

Department of the Treasury  
Internal Revenue Service

4.10.4

AUGUST 29, 2025

## EFFECTIVE DATE

(08-29-2025)

## PURPOSE

- (1) This transmits revised IRM 4.10.4, Examination of Returns, Examination of Income.

## MATERIAL CHANGES

- (1) Editorial revisions to this IRM are listed below:

Reference	Description of Change
4.10.4.1 through 4.10.4.1.6	Added internal control framework as required per IRM 1.11.2.2.5, Address Management and Internal Controls. Incorporated prior Overview into new content added to provide background information, legal authorities that govern the actions covered in this IRM, responsibilities, terms, acronyms, and related resources available to assist examiners when examining income. Moved IRM 4.10.4.2, Definitions, to IRM 4.10.4.1.4, Terms.
4.10.4.2, Minimum Requirement for Examination of Income 4.10.4.2.1, Exception to the Minimum Requirements 4.10.4.2.1.1, Minimum Income Probe Deviations 4.10.4.2.7, Minimum Income Probes: E-Commerce Income	Incorporated SBSE-04-0924-0048, Mandatory Completion of E-Commerce and/or Internet Use Income Probe into IRM.
4.10.4.2.3.8, Business Ratio Analyses (Individual Business Returns)	Moved 3(e) and 4(d) intact to linked job aid.
4.10.4.2.4.6, Evaluate Internal Controls (Corporations and Other Business Returns)	Moved 4 intact to linked job aid.
4.10.4.5.4.6, Gross Receipts Formula	Moved formula intact to linked job aid.
4.10.4.5.4.6.1, Explanation of Formula for Bank Deposits and Cash Expenditures Method	Moved intact to linked example.
4.10.4.5.4.6.5, Overdrawn accounts	Moved (2) intact to linked job aid.
4.10.4.5.5.3, Gross Profit Margin to Sales	Moved intact to linked example.
4.10.4.6.6.4, Example of Computation	Moved subsection intact to linked example.
4.10.4.5.7.3, Formula for the Net Worth Method	Moved intact to linked job aid.
4.10.4.6.7.4, Example of Net Worth Computation	Removed because referenced Exhibit 9.5.9-1, Net Worth Statement, is no longer available.

Reference	Description of Change
4.10.4.7, Currency Transaction Reports (CTR) Information	Incorporated Interim Guidance Memoranda SBSE-04-1223-0061, Interim Guidance for Addressing Currency Transaction Report Information into IRM.
Exhibit 4.10.4-1, Interview Questions Addressing Accumulated Funds Exhibit 4.10.4-2, Internal Sources of Information Exhibit 4.10.4-3, External Sources of Information Exhibit 4.10.4-4, Example of Financial Status Analysis for Individual Business Return Exhibit 4.10.4-6, Auditing Net Operating Loss Deductions (NOLD) Exhibit 4.10.4-7, Interview Questions Addressing E-Commerce Activities Exhibit 4.10.4-8, Tax Treatment of Diverted Income Exhibit 4.10.4-9, The Bank Deposits and Cash Expenditures Method: Example of Computation of Gross Receipts Exhibit 4.10.4-10, Source and Application of Funds Method: Example of Computation for Cash and Accrual Based Taxpayer	Moved content intact to linked examples and job aids cited throughout the IRM.
Exhibit 4.10.4-5 - Bypassing Powers of Attorney	Removed due to overlapping with IRM 4.11.55.4, By-Pass of a Representative.
Throughout IRM 4.10.4	Minor editorial changes have been made throughout this IRM and website addresses were reviewed and updated as necessary.

## EFFECT ON OTHER DOCUMENTS

This IRM supersedes IRM 4.10.4, Examination of Income, dated December 23, 2016. This IRM incorporates Interim Guidance Memoranda SBSE-04-1223-0061, Interim Guidance for Addressing Currency Transaction Report Information, issued 12/20/2023, and SBSE-04-0924-0048, Mandatory Completion of E-Commerce and/or Internet Use Income Probe issued 09/04/2024.

## AUDIENCE

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4.10.4

Examination of Income

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4.10.4.1  
(08-29-2025)  
**Program Scope and Objectives**

- (1) **Purpose.** This IRM section provides guidance for the examination of income. It includes the minimum income probe requirements for individual and business returns, in-depth examination techniques, and formal indirect methods.
- (2) **Audience.** Small Business/Self-Employed (SB/SE) Field Examination employees.
- (3) **Policy Owner.** The Director, Examination Field and Campus Policy, who reports to the Director, Examination Headquarters.
- (4) **Program Owner.** Field Examination General Processes (FEGP), which is under the Director, Examination Field and Campus Policy.
- (5) **Primary Stakeholder.** The primary stakeholders of this IRM are SB/SE Field Examination employees.
- (6) **Contact Information.** To recommend changes or make any other suggestions related to this IRM section. See IRM 1.11.6.5, Providing Feedback About an IRM Section - Outside of Clearance, for further discussion.

4.10.4.1.1  
(08-29-2025)  
**Background**

- (1) This IRM provides guidance for examining income to determine whether taxable income is accurately reported on the tax return. Minimum income probes are required for all examinations based on the return type. Consideration should be given to tax return information, responses to interview questions, the taxpayer's books and records, and other financial information when completing an examination of income. As new information becomes available; examiners should use their judgment when determining the depth of the examination of income.
- (2) It is advisable to include a statement on the initial information document request (IDR) indicating that the examiner may request additional records as the examination progresses. This will help prevent any potential misunderstanding about the scope and depth of the examination of income.

4.10.4.1.2  
(08-29-2025)  
**Authority**

- (1) By law, the IRS has the authority to conduct examinations under Title 26, Internal Revenue Code, Subtitle A – Income Taxes, Chapter 1, Normal Taxes and Surtaxes, Subchapter B, Computation of Taxable Income, Part I, Definition of Gross Income, Adjusted Gross Income, Taxable Income, Etc.:
  - IRC 61, Gross income defined
  - IRC 7521, Procedures involving taxpayer interviews
  - IRC 7602, Examination of books and records

4.10.4.1.3  
(08-29-2025)  
**Roles and Responsibilities**

- (1) The Director, Examination Headquarters, is the executive responsible for providing policy and guidance for field employees and ensuring consistent application of policy, procedures and tax law to effect tax administration while protecting taxpayers' rights. See IRM 1.1.16.5.5, Examination Headquarters.
- (2) The Director, Examination Field and Campus Policy, reports to the Director, Examination Headquarters, and is responsible for the delivery of policy and guidance that impacts the field examination process. See IRM 1.1.16.5.5.1, Examination Field and Campus Policy.
- (3) Field Examination General Processes (FEGP), which is under the Director, Examination Field and Campus Policy, is the group responsible for providing

policy and procedural guidance on standard examination processes to field employees. See IRM 1.1.16.5.5.1.1, Field Examination General Processes.

- (4) All examiners must perform their professional responsibilities in a way that supports the *IRS Mission*. This requires examiners to provide top quality service and to apply the law with integrity and fairness to all.
- (5) Examiners and their managers should thoroughly acquaint themselves with the examination procedures and information contained in this IRM, as well as other resources, such as those listed in, IRM 4.10.4.1.8, Related Resources, below.

4.10.4.1.4  
(08-29-2025)  
**Program Management  
and Review**

- (1) Periodic program reviews are conducted to:
  - Assess the effectiveness of specific programs within Examination or across the organization,
  - Determine if procedures are being followed,
  - Validate policies and procedures, and
  - Identify and share best/proven practices.

4.10.4.1.5  
(08-29-2025)  
**Program Controls**

- (1) SB/SE Field Examination managers verify program and procedural compliance by conducting case consultations, case reviews, performance reviews, and security reviews. Prescribed internal controls are detailed in IRM 1.4.40, SB/SE Field and Office Examination Group Manager, which communicates responsibility to SB/SE Field Examination managers for promoting quality case work and required internal controls. RGS, Embedded Quality Review, and National Quality Review Systems provide the case access, data, and reports used by managers to monitor internal controls.

4.10.4.1.6  
(05-27-2011)  
**Terms**

- (1) The following definitions are provided to clarify terms used within this IRM section. An understanding of these definitions is helpful to complete the examination of income.

4.10.4.1.6.1  
(08-09-2011)  
**Nonbusiness Returns**

- (1) Individual tax returns with no attached business schedule(s) (i.e., no Schedule C, Profit or Loss from Business (Sole Proprietorship) or Schedule F, Profit or Loss from Farming).
- (2) For office audit, individual returns which have attached business Schedule(s) C and/or Schedule(s) F, for which gross business receipts is NOT a classified issue.

4.10.4.1.6.2  
(08-09-2011)  
**Business Returns**

- (1) All types of returns other than nonbusiness returns described in IRM 4.10.4.1.6.1, Nonbusiness Returns.
- (2) For office audit, individual returns which have attached business Schedule(s) C and/or Schedule(s) F, for which gross business receipts is a classified issue.
- (3) An individual business return is an individual return that also includes a business activity, such as a Schedule C sole proprietorship, reflects financial activities of both living person(s) and/or an entity. For purposes of auditing an individual business return, the financial activities of the business entity and the individuals are audited simultaneously as one taxpayer.



- (4) Corporations and other business returns are considered separate legal entities from the owners of the business (i.e., the business entity and its owner file separate tax returns). However, since the business entity is controlled by the owners, it is subject to manipulation and the diverting of income or camouflaging of financial transactions. For purposes of auditing a business return, the audit will be expanded to include the tax returns of the related owner only if specific criteria are met. See IRM 4.10.4.2.4.3. All of the steps for the minimum income probes of a business entity should include an evaluation of potential for diverting income or camouflaging transactions with related owners of the business.

4.10.4.1.6.3  
(05-27-2011)

**Gross Receipts or Gross Income**

- (1) The term **gross receipts** or **gross income** means the taxpayer's total or **gross taxable** receipts during the year from all sources. Gross receipts is not reduced by returned sales, allowances, cost of goods sold, basis, or expenses. Gross receipts includes, but is not limited to the following:
- a. Gross sales of a trade or business;
  - b. Gross fees and commissions;
  - c. Gross wages, salaries, tips, and gratuities;
  - d. Gross dividends, interest, rents, royalties, pensions, and annuities;
  - e. Gross income from estates, trusts, and partnerships;
  - f. Gross proceeds from the sale of assets; and
  - g. Gross farm income.

4.10.4.1.6.4  
(05-27-2011)

**Gross Business Receipts**

- (1) The term **gross business receipts** means the gross receipts derived from a trade, business, farm, or profession. The distinction between **gross receipts** and **gross business receipts** is important when examining nonbusiness returns or business returns which also include nonbusiness income.

4.10.4.1.6.5  
(05-27-2011)

**Cash-on-Hand**

- (1) Generally, cash-on-hand is currency (not balances in bank/financial accounts) associated with routine business practices and/or the need to complete cash transactions with customers.

4.10.4.1.6.6  
(05-27-2011)

**Accumulated Funds**

- (1) Accumulated funds is currency accumulated by the taxpayer, but not associated with routine business practices and/or transactions with customers. The funds may have been taxed in prior years, originate from nontaxable sources, or may represent taxable income in the year under audit.

4.10.4.1.6.7  
(08-09-2011)

**Specific Item Method**

- (1) The specific item method involves the use of direct evidence to determine the tax liability based on omitted income, overstated expenses, or both. For example, funds from known sources are tracked to deposits made to a taxpayer's bank/financial account rather than analyzing bank deposits to identify unreported income from likely sources.
- (2) Direct evidence is evidence from which only one logical conclusion can be reached. Direct documentary evidence is generally regarded as having the greatest value; so, examiners should ask to see the original documents when there is reason to believe they exist. Documentary evidence should not be relied upon to the exclusion of facts established through oral testimony or other techniques, such as a tour of the business site.
- (3) The specific item method is appropriate when the taxpayer maintains books and records, adjustments are due to technical issues (such as timing or

character of funds), or the potential sources of unreported income are limited (such as an insurance agent who underwrites for several companies).

- (4) The specific item method is not useful if the taxpayer's gross receipts are generated from numerous sources or in small amounts, such as a grocery store.
- (5) See IRM 4.10.7.3, Evaluating Evidence, for complete discussion.

4.10.4.1.6.8  
(08-09-2011)  
**Indirect Method**

- (1) The indirect method involves the use of circumstantial evidence to determine the tax liability based on omitted income, overstated expenses, or both. Circumstantial evidence is evidence from which more than one logical conclusion can be reached. To support adjustments for additional taxable income, both the credibility of the evidence and the reasonableness of the conclusion must be evaluated before the determination of tax liability is made.
- (2) Analytical reviews and testing of the taxpayer's books and records, as required by the minimum income probes, may result in the identification of additional taxable income based on circumstantial evidence from which an inference can be made. The financial status analysis and bank/financial account analysis are not prohibited by IRC 7602(e), Limitation on the use of financial status audit techniques, simply because an adjustment to taxable income supported by indirect (circumstantial) evidence may be the result.

**Example:** The minimum income probes for an individual business return include a bank/financial account analysis. There is an identifiable potential source of additional taxable income. The records used for the analysis are the bank/financial account statements, which are prepared by a third party, and are credible evidence. The characterization of excess funds as additional taxable income is reasonable because deposits of nontaxable funds are identified and eliminated. See IRM 4.10.4.2.3.7, Bank Account Analysis (Individual Business Returns).

- (3) See IRM 4.10.7.3, Evaluating Evidence, for complete discussion.

4.10.4.1.6.9  
(08-09-2011)  
**Formal Indirect Method**

- (1) The formal indirect methods are audit techniques used to determine the tax liability based on the amount of unreported income.
  - a. IRM 4.10.4.5.3, Source and Application of Funds Method
  - b. IRM 4.10.4.5.4, Bank Deposit and Cash Expenditures Method
  - c. IRM 4.10.4.5.5, Markup Method
  - d. IRM 4.10.4.5.6, Unit and Volume Method
  - e. IRM 4.10.4.5.7, Net Worth Method
- (2) The formal indirect methods are also known as financial status audit techniques. See IRM 4.10.4.5.1, Authority to Use Formal Indirect Methods (Financial Status Audit Techniques), for additional discussion. They are distinguishable from other audit techniques by the following characteristics:
  - a. Reliance on indirect evidence of income,
  - b. In-depth analysis of actual costs that requires the extensive collection of detailed information, and
  - c. Subject to IRC 7602(e), which states, "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.”

- (3) Formal indirect methods are appropriate when:
  - a. The taxpayer’s books and records are missing, incomplete, or irregularities are identified; or
  - b. The financial status analysis indicates a material imbalance of cash flows after consideration of other adjustments identified during the examination.
- (4) See IRM 4.10.4.5.2, Using Formal Indirect Methods to Reconstruct Income, and IRM 4.10.4.2.3.1.

4.10.4.1.7  
(08-29-2025)  
**Acronyms**

- (1) The following table lists commonly used acronyms and their definitions used throughout this IRM:

Acronym	Definition
ADP	Automatic Data Processing
BLS	Bureau of Labor Statistics
BSA	Bank Secrecy Act
CDE	Compliance Data Environment
CFOL	Corporate File On-Line
CTR	Currency Transaction Report
EDI	Electronic Data Interchange
FCQ	Financial Crimes Enforcement Network (FinCEN) Query
FinCEN	Financial Crimes Enforcement Network
IDRS	Integrated Data Retrieval System
IRP	Information Returns Processing
IRPTR	Information Returns Processing Transcript Request
ITM	Integrated Talent Management
LIFO	Last-In, First-Out
LUQ	Large Unusual Questionable Items
NOLD	Net Operating Loss Deduction
PLE	Personal Living Expense
REMIC	Real Estate Mortgage Investment Conduit
RGS	Report Generation Software
SAR	Suspicious Activity Report

4.10.4.1.8  
(08-29-2025)

#### Related Resources

- (1) The following list of IRMs contain additional guidance and information examiners will use:
  - IRM 4.10.2, Pre-Contact Responsibilities
  - IRM 4.10.3, Examination Techniques
  - IRM 4.10.5, Required Filing Checks
  - IRM 4.10.7, Issue Resolution
  - IRM 4.10.8, Report Writing
  - IRM 4.10.9, Workpaper System and Case File Assembly
  - IRM 4.10.15, Report Generation Software
- (2) Helpful information can be found on websites, including, but not limited to the following:
  - *Understanding your Form 1099-K*
  - *Marijuana Cases*
  - *Digital Assets*
  - Examinations of income for all business tax returns should incorporate industry-based *Audit Technique Guides (ATG)*

4.10.4.2  
(08-29-2025)

#### Minimum Requirements For Examination of Income

- (1) All examiners must consider gross income during the examination of all income tax returns.
- (2) Minimum income probes must be completed regardless of the type of return filed by the taxpayer. The minimum income probes are designed as a set of analytical tests intended to determine whether the taxpayer accurately reported income. If the taxpayer is underreporting income, the probes should result in the identification of at least a portion of the understatement.
  - a. The minimum income probes vary depending upon the type of return (nonbusiness or business) and the method of the examination (office audit or field examination).
  - b. The minimum income probes are not subject to IRC 7602(e) governing the use of financial status audit techniques.
  - c. E-commerce and/or internet use activities must be audited as part of the minimum income probes for all business returns, including limited scope audits (i.e., **deviation is prohibited**). See IRM 4.10.4.2.7 for detailed discussion.
  - d. All minimum income probes must be completed regardless of whether or not the taxpayer maintains a double-entry set of books.
- (3) Minimum income probes must be addressed in no show/no response cases. See IRM 4.10.4.2.6.
- (4) Large, unusual, or questionable (LUQ) income items must be considered, in addition to the completion of the minimum income probes.
  - a. IRM 4.10.2.3.1, Large Unusual Questionable Items Defined, advises an LUQ item can be based on comparative size of the item, the absolute size of the item, inherent character of the item, evidence of intent to mislead, beneficial effect of manner in which the item was reported, relationship to other items, possible whipsaw effect on other taxpayers, automatic adjustments, and missing items.

**Example:** An income whipsaw is when income is reported on a joint state return and the examiner cannot determine the appropriate

income to reflect on the federal return for each spouse. The examiner should not automatically report the total income on both spouses returns. The examiner should first check the state tax return for information that would provide a basis for allocating the income reported. Second, the examiner should cross-reference the information on the state return with any other information that may be available, such as information returns (e.g., Form W-2, Wage and Tax Statement, *Form 1099*, etc.). If the examiner has sufficient information to determine the amount of income per spouse, the examiner can prepare a report. If the examiner does not have sufficient information to allocate income based on the steps taken above, the examiner should try to contact each spouse and attempt to obtain information on how much income should be reported for them prior to issuing a report. If the taxpayer(s) are non-responsive or uncooperative, the examiner can then treat this as a whipsaw issue and place the full income on each taxpayer's return. The latter will be done only when the steps outlined above provide insufficient information on how to allocate income. For community property states, the examiners should refer to IRM 25.18.2, Income Reporting Considerations of Community Property. For whipsaw see IRM 4.10.13.5, Adjustments Between Correlative U.S. Taxpayers to Achieve Consistent Tax Treatment, (a/k/a Whipsaw Issues).

- b. An LUQ may be identified during the pre-contact analysis or as information is gathered during the course of an examination.
- c. An LUQ may be based on direct evidence and, in this instance, is not subject to IRC 7602(e) governing the use of financial status audit techniques.

**Example:** When the federal / state matching program indicates a taxpayer has reported significantly less income on the federal return, the examiner can use the income reported on the state tax return to produce a federal tax examination report. It has been held that positions taken in a tax return signed by a taxpayer may be treated as admissions. See *Waring v. Commissioner*, 412 F.2d 800, 801 (3rd Cir. 1969); *Lare v. Commissioner*, 62 T.C. 739, 750 (1974); *Kaltreider v. Commissioner*, 28 T.C. 121, 125 -126(1957). As stated in *Crigler v. Commissioner*, T.C.M. 2003-93, a taxpayer "cannot ... disavow ... returns without cogent proof that they are incorrect." Evidence obtained through the taxpayer's own admission on a state income tax return signed under penalties of perjury is as reliable as evidence from third parties, and perhaps more so if the taxpayer is unable to successfully refute the information contained in the state return. If the taxpayer establishes during the course of the examination that the state information is incorrect, the examiner will adjust their report accordingly.

- (5) When the amount of a net operating loss deduction (NOLD) is material, it constitutes a LUQ item that should be addressed as part of the examination of income. See IRM 4.10.2.3.1, and *Job Aid - Auditing Net Operating Loss Deductions (NOLD)*.

4.10.4.2.1  
(08-29-2025)

**Exception to the  
Minimum Requirements**

- (1) All minimum income probes must be conducted during every examination unless one of the following exceptions applies:
  - The examination is a limited-scope audit (see IRM 4.10.2.7.1.3, Limiting the Scope).
  - One or more deviations from the minimum income probes is warranted (see IRM 4.10.4.2.1.1, Minimum Income Probe Deviations).
 

**Reminder:** Examiners must perform the e-commerce and/or internet use probe for all business examinations, including those designated as limited-scope examinations (i.e., deviation is prohibited).
  - The minimum income probes have been completed for the primary return and no income issues are identified.
 

**Reminder:** Examiners must review the prior and subsequent year returns to ensure there are no LUQ or income issues. If there are no LUQ or income issues, only an Information Returns Processing (IRP) analysis (including consideration of Currency Transaction Reports (CTRs)) is required for a prior or subsequent year return (see IRM 4.10.2.7.1.2(5), Determining the Scope of an Examination – Current, Prior and Subsequent Years).
- (2) The examination workpapers should state that the scope of the audit was modified and cite the reasons.
- (3) Before limiting the scope of an audit of an individual business return, a preliminary financial status analysis based on the tax return and available data will be prepared as outlined in IRM 4.10.4.2.3.1. If the analysis indicates a material imbalance, then further development is required and the minimum income probes must be completed.
 

**Example:** A claim will be examined for a highly technical issue requiring factual development. The preliminary financial status analysis indicated the taxpayer had sufficient funds for the expenditures identified on the return. The scope of the audit can be limited to the technical issue.

**Example:** A taxpayer filed a Form 1040-X, Amended U.S. Individual Income Tax Return, reflecting a significant increase in Schedule C expenses. The statute was open for the claim issue only. The taxpayer verified all the additional expenses during the audit. However, when the additional expenses were included in the preliminary financial status analysis, there was a material imbalance. The scope of the audit should not be limited; the material imbalance should be resolved.
- (4) Before limiting the scope of an audit of a related return, examiners should:
  - Determine whether or not the related return warrants examination from a classification perspective (i.e., trace transactions between the related entities),
  - Complete a preliminary financial status analysis for individual returns based on the related return as filed and internal sources of information (*Job Aid - Internal Sources of Information*), and
  - Review the return for other potential issues. See IRM 4.10.5.4, Related and Spin-Off Returns.



- (5) When the minimum income probes have been completed for the primary return and no income issues are identified, minimum income probes are not required for a prior or subsequent year return. However, examiners must review the prior and subsequent year returns to ensure there are no LUQ or income issues. Examiners must document the conclusions reached.
- (6) The examination workpapers should state that the scope of the audit was limited and cite the reasons.

4.10.4.2.1.1  
(08-29-2025)

**Minimum Income Probe  
Deviations**

- (1) Examiners may find that one or more of the minimum income probes cannot be performed in a particular case or no value is added by performing a specific minimum income probe. The decision to deviate from one or more of the minimum income probe requirements must be based on the specific facts of the case as they relate to the taxpayer.

**Reminder:** Deviation from completion of e-commerce and/or internet use minimum income probe for business returns is prohibited.

- (2) When the examiner determines a deviation from a minimum income probe is warranted, the reason(s) must be documented in the appropriate minimum income probe workpapers. The factors considered and rationale for deviating must be specifically documented. The documentation must clearly support the decision.

**Caution:** This section cannot be used to deviate or otherwise limit the minimum income probes due to workload or other factors (e.g., training) not related to the taxpayer.

4.10.4.2.2  
(08-09-2011)

**Minimum Income  
Probes: "Nonbusiness"  
Returns**

- (1) **IRP Reconciliation** - Prepare an IRP analysis of the taxpayer's IRP information to ensure all business and/or investment activities reflected on the IRP document(s) are properly accounted for on the tax return.
- (2) **Interview** - The taxpayer should be interviewed. From the taxpayer's perspective, an interview with an examiner may be overwhelming. Interviews should be professional and not overbearing. Question the taxpayer concerning possible sources of income, other than those reported, and accumulated funds. **This would include potential bartering activities questions.**
- (3) **Financial Status Analysis** - A financial status analysis must be completed for **office audit** nonbusiness returns which include a Schedule C or Schedule F, but for which the gross receipts is not a classified issue. See IRM 4.10.4.1.6.1, Nonbusiness Returns. At a minimum, the analysis should be based on information disclosed on the tax return as filed, information included as part of the case building, and information available through internal sources. See IRM 4.10.4.2.3.1. The T-Account provides a quick and easy format for documenting whether there is an indication of a potential understatement of taxable income (i.e., a material imbalance as defined in IRM 4.10.4.3). Enter sources of cash funds on the left side of the T-Account and expenditures of cash funds on the right side. Total sources are compared with total expenditures. If the analysis does not indicate a material imbalance, the conclusions should be documented in the examination workpapers.
- (4) If the preliminary financial status analysis indicates a material imbalance:

- a. Use subsequent interviews and information gathered during the audit to update the analysis and resolve the imbalance. The analysis should be updated as audit adjustments are identified. When completed, the analysis should indicate that either income is sufficient to support the taxpayer's financial activities or there is a significant imbalance indicating the potential for unreported income.
- b. Expand the minimum income probes to include an analysis of the taxpayer's bank/financial accounts. The purpose of the analysis is to identify deposits that may be taxable income and identify sources of taxable income not otherwise disclosed by the taxpayer. See IRM 4.10.4.2.3.7 for general guidelines.

(5) **Financial Status Analysis** - A financial status analysis must be completed for nonbusiness returns, **if it appears the taxpayer does not have sufficient funds** for even the most minimal personal living expenses including those reflected on Schedule A (or the standard deduction) plus the exemption deduction. The T-Account provides a quick and easy format for documenting whether there is an indication of a potential understatement of taxable income.

- a. The imbalance must be specifically addressed during the audit (i.e., use interviews and information gathered during the audit to update the analysis and resolve the imbalance). The analysis should be updated as audit adjustments or sources of funds are identified. When completed, the analysis should indicate that either income is sufficient to support the taxpayer's financial activities or there is a significant imbalance indicating the potential for unreported income.
- b. Enter sources of cash funds on the left side of the T-Account and expenditures of cash funds on the right side.
- c. The results of a financial status analysis and the conclusions should be documented in the examination workpapers.
- d. See IRM 4.10.4.2.3.1 for complete discussion.

4.10.4.2.2.1  
(05-27-2011)  
**Nonbusiness Returns  
Examination of Bank  
Information**

- (1) With regards to IRC 7602(e), which addresses the use of financial status audit techniques, examiners should not routinely ask for bank statements, cancelled checks or deposit slips to complete the examination of income on **nonbusiness** returns. Requests for documentation supporting specific issues can be made and may include cancelled checks.
- (2) There may be situations in which there is a reasonable indication of unreported income in the pre-contact stage of the examination (i.e., a grossly imbalanced financial status analysis or *Form 1099* for business income not included on the tax return). In such situations, the initial IDR may include a request for personal banking records, including bank statements, cancelled checks, and deposit slips.

4.10.4.2.2.2  
(05-27-2011)  
**Deviation on  
Nonbusiness Minimum  
Income Probes**

- (1) Examiners may find that one or more of the minimum income probes cannot be performed in a particular case or that no value is added by performing a specific minimum income probe. The decision to deviate from one or more of the minimum income probe requirements must be based on the specific facts of the case as they relate to the taxpayer.
- (2) When the examiner determines a deviation from a minimum income probe is warranted, the reason(s) must be documented in the appropriate minimum



income probe workpapers. The factors considered and rationale for deviating must be specifically documented. The documentation must clearly support the decision.

**Caution:** This section cannot be used to deviate or otherwise limit the minimum income probes due to workload or other factors not related to the taxpayer.

4.10.4.2.3  
(08-09-2011)  
**Minimum Income  
Probes: Individual  
“Business” Returns**

- (1) **Financial Status Analysis** - Prepare a financial status analysis to estimate whether reported income is sufficient to support the taxpayer's financial activities. See IRM 4.10.4.2.3.1.
- (2) **Interview** - Conduct an interview with the taxpayer (or representative) to gain an understanding of the taxpayer's financial history, identify sources of nontaxable funds, and establish the amount of currency the taxpayer has on hand. Consider possible bartering income as part of the minimum income probes. See IRM 4.10.4.2.3.2.
- (3) **Tour of Business** - Tour the business site and review of the Internet website to gain familiarity with the taxpayer's operations and internal controls, and identify potential sources of unreported income. However, a tour of the physical business site is not required for office audit cases but may be conducted if appropriate and with manager approval. See IRM 4.10.4.2.3.3.
- (4) **Internal Control** - Evaluate internal controls to determine the reliability of the books and records (including electronic books and records), identify high risk issues, and determine the depth of the examination of income. See IRM 4.10.4.2.3.4.
- (5) **Reconciliation of Income** - Reconcile the income reported on the tax return to the taxpayer's books and records. An analysis of the IRP information in the file should also be completed to ensure all business and/or investment activities reflected on the IRP document are properly accounted for on the tax return. See IRM 4.10.4.2.3.5.
- (6) **Testing Gross Receipts** - Test the gross receipts by tying the original source documents to the books. See IRM 4.10.4.2.3.6.
- (7) **Bank Analysis** - Prepare an analysis of the taxpayer's personal and business bank/financial accounts (including investment accounts) to evaluate the accuracy of gross receipts reported on the tax return. See IRM 4.10.4.2.3.7.
- (8) **Business Ratios** - Prepare an analysis of business ratios to evaluate the reasonableness of the taxpayer's business operations and identify issues needing a more thorough examination. See IRM 4.10.4.2.3.8.
- (9) **E-Commerce and/or Internet Use** - Determine if there is internet use and e-commerce income activity. See IRM 4.10.4.2.7.1.

4.10.4.2.3.1  
(08-09-2011)  
**Financial Status  
Analysis (Individual  
Business Returns)**

- (1) Prepare a financial status analysis of the taxpayer's cash flow to **estimate** whether there are sufficient funds to cover the taxpayer's expenses. The financial status analysis includes both business and personal financial activities. The analysis serves two purposes:
  - a. Determining the depth of the examination of income, and

- b. Establishing that there is a reasonable likelihood of unreported income that justifies the use of a formal indirect method.
- (2) The intent of the analysis is to determine whether there is a significant risk of a material misstatement of taxable income. Materiality is the significance or importance of an item in determining the correct tax liability and requires the examiner's judgment regarding the return as a whole and the separate items that comprise the return. Among the factors which must be considered when determining whether the imbalance is material are:
  - a. Absolute amount of the imbalance;
  - b. Results of multi-year analyses;
  - c. Ratios and industry standards (it is recommended that the ratio analysis include three tax years, to the extent information is available, to provide a comprehensive financial picture and allow for trend analysis);
  - d. Relationship between the size of the imbalance and the tax liability.
- (3) The financial status analysis should include consideration of all sources and expenditures of funds identified on the tax returns, information included as part of the case building, and sources of information such as asset locator people locator contract, Financial Crimes Enforcement Network (FinCEN), Information Document Retrieval System (IDRS), Corporate Files on Line (CFOL), and/or Compliance Data Environment (CDE). See *Job Aid - Internal Sources of Information*. Reasonable estimates for other expenses known to exist, but for which the exact costs are not known should be included in the analysis. Personal living expenses (PLE) must be estimated using Bureau of Labor Statistics (BLS) information or comparable statistics from a reliable source, except where the actual amount of the expense is disclosed on the tax return.

**Example:** Total PLE based on BLS data is \$25,000, of which \$4,000 represents home mortgage interest. The taxpayer included \$8,000 as home mortgage interest on Schedule A. The BLS data should be revised to account for the actual mortgage interest expense. Total PLE = \$25,000 - \$4,000 + \$8,000 = \$29,000.
- (4) The analysis should also be updated during the examination as additional information becomes available (i.e., nontaxable sources of funds or disallowed expenses). See *Example - Financial Status Analysis for Individual Business Return* on how to complete a T-Account.
- (5) The T-Account provides a quick and easy format for documenting and determining whether there is an indication of a potential understatement of taxable income. Enter sources of funds on the left side of the T-Account and expenditures of funds on the right side. Total sources are compared with total expenditures.
- (6) Steps for completing a financial status analysis:
  - a. Prepare the financial status analysis (i.e., using the T-Account format) based upon the tax return data and information in the case file (e.g., records of monetary transactions FinCEN). Use BLS or comparable statistics from another reliable source to estimate the taxpayer's personal living expenses. If the analysis indicates a material imbalance, the excess expenditures are considered to be a potential understatement of taxable income which requires further development during the audit.

- b. An analysis of IRP information in the file should be completed to evaluate if there are any additional sources of income. Income not included on the tax return should be included in the T-Account.
  - c. Use subsequent interviews and information gathering during the examination to update the financial status analysis and resolve any imbalance. For example, when the profit margins are consistently low, but the taxpayer is able to continuously service substantial debt (mortgage), the examiner should make further inquiries.
  - d. The analysis should be updated as audit adjustments are identified. The adjustment may be the result of unreported gross receipts, overstated expenses, or from a combination of these items.
  - e. When completed, the financial status analysis should indicate that either income is sufficient to support the taxpayer's expenditures or there is a significant imbalance indicating the potential for unreported income.
- (7) The completion of a financial status analysis does not trigger the provisions of IRC 7602(e), which states, "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." A financial status analysis is an analytical tool used to identify and estimate the materiality of cash flow imbalances. Financial Status Audit Techniques are the formal indirect methods used to make the actual determination of tax liability and are subject to the limitations of IRC 7602(e). See IRM 4.10.4.5, Formal Indirect Methods of Determining Income.
- (8) Income or losses reported on Schedule E, Supplemental Income and Loss, may not represent an actual flow of funds.
- a. If the taxpayer is reporting income or loss from a partnership, S corporation, estate, or trust, review, for example, *Form 1120-S Schedule K-1*, Shareholder's Share of Income, Deductions, Credits, Etc., to identify actual capital contributions, withdrawals or distributions.
  - b. If the taxpayer is reporting income or a loss from a Real Estate Mortgage Investment Conduit (REMIC), review Schedule Q, Form 1066, U.S. Real Estate Mortgage Investment Conduit (REMIC) Income Tax Return.
- (9) An examiner may consider observing a taxpayer's residence when completing a financial status analysis. However, observing a taxpayer's home should not be intrusive and generally should not include talking with the taxpayer's neighbors. Inspections of the inside of a taxpayer's home should be limited due to privacy issues and the intrusive nature.

**Note:** the purpose of inspecting the interior of a taxpayer's home includes determining the validity of a deduction for an office or business located in the residence.

**Example:** An examiner believes, based on the address on the tax return, that the taxpayer's home is located in a recently developed subdivision where the homes are selling for more the \$300,000. The preliminary financial status analysis indicates that the taxpayer could not support the purchase or maintenance of such a home based on the reported income. The examiner drives by the home and discovers that the taxpayer lives in a modest 40-year-old home across the street from the new subdivision.

- (10) The financial status analysis, as originally prepared based upon the tax return data and information in the case file and subsequently modified, will be made part of the examination workpapers. The analysis should indicate the information considered and the conclusions reached.
- (11) If the financial status analysis indicates that the taxpayer's sources of funds are not sufficient to support the taxpayer's expenditures; the use of a formal indirect method can be justified.
- (12) See *Job Aid - Common Errors when Completing T-Accounts*.

4.10.4.2.3.2  
(08-09-2011)  
**Initial Interview  
(Individual Business  
Return)**

- (1) The examiner should conduct the initial interview with the taxpayer to gain an understanding of the taxpayer's overall financial picture, the business history and operations, and an overview of the taxpayer's recordkeeping practices. Interviews should be professional and not overbearing.
- (2) IRC 7521(c), Representatives holding power of attorney, states that an examiner cannot require a taxpayer to accompany an authorized representative to an examination interview in the absence of an administrative summons. However, the taxpayer's voluntary presence can be requested through the representative as a means to expedite the examination process. Should an examiner find that a representative has unreasonably delayed or hindered an examination, an examiner can bypass the representative and deal directly with the taxpayer, as outlined in IRM 4.11.55.4, By-Pass of a Representative.
- (3) Question the taxpayer/representative concerning possible nontaxable sources of funds, gifts, loans, known errors/omissions on the return, and unreported sources of income. These questions should be addressed at the initial interview early in the examination. The information will be needed to reconcile the financial status analysis, analyze the bank/financial accounts, and reconcile the income reported on the tax return to the books and records. Also, the information will be critical should it later become necessary to use a formal indirect method to make the actual determination of tax liability.
  - a. If loan proceeds are identified, verify the source and amount of the non-taxable funds.
  - b. If the loan is from a financial institution, consider whether the loan amount is consistent with the taxpayer's financial picture as represented on the tax return. Evaluate for consistency with other evidence (i.e., cash flows, anticipated gross receipts, etc.). If inconsistencies are identified, request the loan application and attachments. Review the financial statements submitted with the application; look for information such as the disclosure of sources of income not included on the tax return or the disclosure of more profit than reported on the return. Consider when evaluating the credibility of the taxpayer's oral testimony and accuracy of the taxpayer's books and records.
  - c. If the loan or gifts are from family members or other individuals, verification may be difficult. The examiner should inquire as to why the amount provided was cash, when the amount was given, how it was given (one payment or multiple), and any provisions for repayment. Discrepancies should be resolved with the taxpayer's assistance. Nontaxable sources of funds can be eliminated by showing that the provider of the funds was incapable of generating the amounts stated by the taxpayer (i.e., the absence of any documentation reflecting the source of the funds and/or the absence of sources of funds available to the provider).

- d. Refer to IRM 4.10.7.3, Evaluating Evidence, for additional guidance.
- (4) If the IRP analysis reveals that there are additional known sources of income not included on the tax return, the examiner should question the taxpayer as to where they may have already reported this information.
- (5) Question the taxpayer concerning bartering income. Bartering is the trading of one product or service for another. Usually there is no exchange of cash. Bartering may take place on an informal one-on-one basis between individuals and businesses, or it can take place on a third party basis through a modern barter exchange company.
- (6) Obtain the beginning and ending balances for cash-on-hand from the taxpayer or representative for the year(s) under examination. See IRM 4.10.4.5.8.3 for complete discussion and *Interview Questions - Addressing Accumulated Funds*. Generally, cash-on-hand is currency associated with normal business practices and the need to complete cash transactions with customers. If additional years are examined, be sure to determine and document the beginning and ending cash-on-hand for those years. This information will be needed to complete the reconciliation of income as reported on the tax return to the taxpayer's books and records and will be critical should it later become necessary to use a formal indirect method to make the actual determination of tax liability.
- (7) Determine the beginning and ending balances of accumulated funds for the year(s) under examination. Generally, accumulated funds is currency not associated with normal business practices. The funds may have been taxed in prior years, originate from nontaxable sources, or may represent taxable income in the year under audit. See IRM 4.10.4.5.8, Potential Taxpayer Defenses Against Formal Indirect Methods of Computing Income, for complete discussion and *Interview Questions - Addressing Accumulated Funds*.
- (8) The examiner should ask the taxpayer for assistance to resolve a financial status analysis indicating a material imbalance.

**Example:** The examiner completes a pre-contact analysis of an individual taxpayer's return with a Schedule C. Based upon an analysis of the taxpayer's cash flows **on the face of the return**, the examiner believes the reported income is insufficient to support the taxpayer's expenses. The examiner may ask the taxpayer how the expenditures were paid, based on the income reported on the return.

- (9) The examiner should ask the taxpayer to explain the accounting system, including:
  - a. The normal flow of each type of transaction from its initiation to its inclusion in the financial statements, and
  - b. The flow of funds into and out of the business.
- (10) The examiner should question the taxpayer regarding business policies and practices for:
  - a. Product pricing and determining profit margins,
  - b. Accounting for cost of goods sold, and
  - c. Accounting for spillage, breakage, and theft losses.

- (11) The examiner should determine the extent of the taxpayer's use of the internet for e-commerce purposes. See *Interview Questions - Addressing E-Commerce Activities*.
- (12) IRC 7521 (b)(2), Recording by IRS officer or employee, requires examiners to suspend interviews when taxpayers state that they wish to consult with a representative or otherwise seek advice. The taxpayer's right of consultation will be strictly observed and interviews will be suspended and rescheduled accordingly. This provision does not apply to interviews initiated by administrative summons and will not be used to repeatedly delay or hinder the examination process.
- (13) Examiners should use the appropriate lead sheet in Report Generation Software (RGS) to document the interview.
- (14) Refer to IRM 4.10.7.3.2, Oral Testimony, for complete discussion and documentation requirements.

4.10.4.2.3.3  
(05-27-2011)

**Tour of Business Sites  
(Individual Business  
Return)**

- (1) Conduct a tour of the physical business site controlled by the taxpayer. Generally, the physical business site will be the principal location and any other locations acquired during the period under examination should be visited. The purpose of a tour is to:
  - a. Gain familiarity with the taxpayer's business operation and internal controls,
  - b. Identify potential sources of unreported income, and
  - c. Confirm the existence of assets.
- (2) A tour of the physical business site is not required for office audit cases. However, if appropriate (and with manager's approval), a tour of the business site may be conducted.
- (3) The results of a tour and any observations and/or comments should be documented in the examination workpapers.
- (4) See IRM 4.10.3.5, Tours of Business Sites, for complete discussion.
- (5) Review the business websites controlled by the taxpayer. See IRM 4.10.4.2.7.2.

4.10.4.2.3.4  
(08-09-2011)

**Evaluation of Internal  
Controls (Individual  
Business Return)**

- (1) Evaluate the internal controls to gain an understanding of the taxpayer's business operations and control features. The evaluation will help examiners set the scope and depth of the examination of income and determine the appropriate audit techniques.
- (2) Examiners should:
  - a. Document the business operation
  - b. Document the accounting system
  - c. Document assets
  - d. Document the flow of transactions
  - e. Document procedures established for safeguarding business operations
- (3) The evaluation should not be limited to a consideration of the segregation of duties. See IRM 4.10.3.6, Evaluating the Taxpayer's Internal Controls, for a complete discussion. Examiners should:



- a. Determine the reliability of the books and records, regardless of the sophistication of the recordkeeping method. Refer to IRM 4.10.4.2.7.5 if the taxpayer maintains electronic books and records.
  - b. Gain an understanding of the taxpayer's business operations (i.e., how income is generated and recorded).
  - c. Determine how business assets are safeguarded (i.e., what steps the taxpayer takes to ensure that the business operates as intended and avoid misstatements of financial information).
- (4) While there is no exhaustive definition of weak internal accounting controls which will impact the scope and depth of the examination of income, examples include:
- a. Books and records that cannot be reconciled to the tax return
  - b. Transactions that are not properly authorized
  - c. Recorded transactions are not valid
  - d. Existing transactions are not recorded
  - e. Transactions are improperly valued
  - f. Transactions are improperly classified
  - g. Transaction are recorded at the improper time
  - h. Transactions are incorrectly summarized
  - i. Transactions all made by the same person or related parties
  - j. Significant commingling of business and personal funds
- (5) Weak internal controls alone do not necessarily establish a reasonable likelihood of unreported income under IRC 7602(e) that justifies the use of a formal indirect method to make the actual determination of tax liability. Examiners must also demonstrate that there are irregularities in the taxpayer's books and records. See IRM 4.10.4.2.3.5.

**Example:** The fact that a taxpayer does not maintain separate business and personal bank/financial accounts does not, per se, warrant the use of a formal indirect method to make the actual determination of tax liability. The examiner must first:

- (1) Determine the reliability of the books and records,
- (2) Reconcile the books and records to the return, and
- (3) Identify the sources of funds to properly account for taxable income.

The examiner can use a formal indirect method to determine the tax liability if there is a reasonable indication that there is a likelihood of unreported income.

- (6) The workpapers must document the conclusions reached by the analysis of internal controls and their impact on the scope and depth of the examination.

4.10.4.2.3.5  
(08-09-2011)

**Reconciliation of Income per Books and Records to Income Reported on Tax Return (Individual Business Returns)**

- (1) Reconcile the income reported on the tax return to the taxpayer's books and records. Ask the taxpayer how income was computed and duplicate the taxpayer's steps. Refer to IRM 4.10.3.7.6, Step 6: Reconciling the Taxpayer's Books and Records to the Tax Return, for complete discussion.
- (2) Analyze the information obtained in the initial interview, observed during the tour of the business site, and from the evaluation of the internal controls to determine if transactions were properly recorded.
  - a. Determine whether information provided by the taxpayer in the interview(s) is reflected in the book and records.

- b. Confirm that income from all assets observed during the tour of the business is included in income.
  - c. Based on the evaluation of internal controls, identify weaknesses which could be overridden or compromised, allowing for the diversion of income. Test the weaknesses to determine whether income actually was diverted.
- (3) Test whether income from e-commerce activities has been accounted for in the books and records and reported on the tax return. See IRM 4.10.4.2.7.
- (4) If the income per the books and records cannot be reconciled with the income reported on the tax return, the examiner should ask the taxpayer to provide an explanation for the difference (i.e., how the accounts per books were accumulated for the tax return).
- (5) Irregularities in a taxpayer's books and records, or inconsistencies in reporting transactions may be an indication of unreported income justifying the use of a formal indirect method to determine the actual understatement of taxable income.

**Example:** A taxpayer's books and records are reconciled to the income tax return. No discrepancy is noted when reconciling income to the bank statements and sales journals, or verifying purchases by inspecting cancelled checks and invoices. The examiner also attempted to tie purchases to specific jobs and the income received from those jobs. For a few purchases, there was no corresponding job or income reported.

- (6) The lack of books and records or the underlying source documents must justify expansion of an income probe beyond the minimum income probes.

**Example:** The taxpayer owns and operates a cash-intensive food service business. The taxpayer's books and records tie to the tax return. As part of the audit, the examiner should test gross receipts by tying the original source documents (cash register receipts and/or invoices) to the books. However, the taxpayer does not have the original documents.

- (7) The fact that a taxpayer's books and records were not prepared contemporaneously to the business activity does not, per se, permit the examiner to use a formal indirect method to make the actual determination of tax liability. The test of whether a formal indirect method can be used is whether there is a reasonable indication that there is a likelihood of unreported income.

**Example:** A taxpayer advises the examiner during an audit that the books were prepared after the end of the tax year based on bank statements and cancelled checks.

4.10.4.2.3.6  
(08-09-2011)  
**Testing Gross Receipts  
(Individual Business  
Returns)**

- (1) Test gross business receipts to verify that all the gross receipts are accounted for. For additional techniques, see IRM 4.10.3.11, Testing Gross Receipts or Sales.
  - a. Trace original entries in the books back to the original sales document (e.g., sales slips, cash register receipts, or job contracts, etc.).
  - b. Trace original sales documents to the corresponding entries in the books.
  - c. If original sales documents are numbered or otherwise sequenced, identify and account for missing sales documents.



- d. Determine the method and adequacy of the accounting for merchandise withdrawn for personal use.
- e. Scan sales agreements, contracts and other related documents to identify unreported bonuses, awards, kickbacks, etc.
- f. Determine that all accounts receivables are included in income for accrual basis taxpayers.

4.10.4.2.3.7  
(08-09-2011)

**Bank Account Analysis  
(Individual Business  
Returns)**

- (1) Perform an analysis of the taxpayer's business and personal bank/financial accounts (including investment accounts) (i.e., statements, deposit slips, and canceled checks, etc.). The examiner should use judgment to determine the depth of the analysis and use of automation. The IRS is not prohibited from asking for these records, as well as wire transfers, on the initial IDR or at any time during the examination for an individual business return. See IRM 4.10.4.2.
- (2) This analysis is used to:
  - a. Identify deposits which **may** be taxable income,
  - b. Determine whether business expenses **may** have been paid from other sources (such as cash-on-hand or accumulated funds) or are overstated,
  - c. Estimate the risk of commingled personal and business bank/financial accounts, and
  - d. Determine whether cash is deposited.
- (3) The steps of the bank/financial account analysis are:
  - a. Analyze the deposits. Look for unusual deposits (size or source), frequency of deposits. Also check for deposits of cash, specific deposits that do not follow the taxpayer's normal routine or pattern, nontaxable deposits such as loans and transfers, commingling of personal and business activities, and cash-back when a deposit is made.
  - b. Total the deposits and reconcile deposits of nontaxable funds and transfers between accounts. Particular attention should be paid to transfers in, out, and between accounts as previously unknown accounts may be identified. Checks deposited by the taxpayer but later returned by the bank (e.g., the maker of the check did not have sufficient funds in the account to pay the check) should be categorized as a nontaxable transaction.

**Reminder:** Nontaxable funds, transfers-in, and returned deposits need to be subtracted from total deposits to get "Taxable Deposits."

**Note:** This step is a duplication of the reconciliation of income reported on the tax return to the taxpayer's books and records if the taxpayer reported income based on bank deposits.

- c. Determine disbursements by adding the opening bank balance to the total deposits and then subtracting out the ending balance.
- d. To the extent possible, conduct a review of cancelled checks to determine whether nondeductible expenditures (personal expenses, investments, payments on asset purchases, etc.) are included with business expenses and if so, the dollar amount. If cancelled checks are unavailable, trace transactions from the bank statement to the check register and original document. Significant commingling of accounts warrants a more in-depth analysis.

- e. Subtract the nondeductible expenditures from the total disbursements. The remainder should approximate the deductible business expenses on the tax return (other than non-cash expenses such as accruals and depreciation).

**Note:** It may be easier to identify the business expenditures in some cases, which can then be subtracted from the total disbursements; the remainder will be personal expenses paid by check.

- (4) Compare the total deposits with the reported Gross Income. Include all accounts, whether designated as personal or business.
- (5) If the analysis results in the identification of excess deposits over the reported gross income, the excess represents potential unreported income.
  - a. If specific transactions or deposits can be identified as the source of the understatement, a specific item adjustment to income supported by direct evidence should be made.
  - b. If the specific transactions or deposits creating the understatement are not identified, an adjustment to taxable income may be made based on the circumstantial evidence. Technically, this is an adjustment due to the use of an indirect method. However, IRC 7602(e) governing the use of financial status audit techniques, is not triggered because the adjustment stems from an analysis of the taxpayer's books and records and does not require the extensive collection of detailed information. IRM 4.10.4.1.6.8, Indirect Method.
- (6) If the business expenditures paid by check are less than the deducted business expenses on the return, then the taxpayer may be overstating expenses, paying expenses by cash (unreported income), or paying expenses from an undisclosed source of funds.
- (7) If the analysis indicates significant commingling of funds, then the internal controls are weak and the books and records may be unreliable. IRM 4.10.4.2.3.4.
- (8) A potentially material misstatement of taxable income identified through a bank/financial account analysis establishes a reasonable likelihood of additional unreported taxable income justifying the use of a formal indirect method to make the actual determination of tax liability.

4.10.4.2.3.8  
(08-29-2025)  
**Business Ratio Analyses  
(Individual Business  
Returns)**

- (1) The initial reconciliation of income per the books and records to the tax return provides the examiner with an understanding of how the taxpayer determined gross receipts. The books and records can also be used to evaluate the accuracy and reasonableness of the reported amount of income through the use of ratios.
- (2) A horizontal analysis should be prepared, with documented conclusions, and be included in the case file for all business returns. A vertical analysis may not be appropriate for every case.
- (3) Horizontal analysis - This analysis identifies changes over time and may result in the identification of LUQ items not readily identified from a review of a single return alone. The tax return under audit should be compared to the prior and subsequent year returns.

- a. Examiners should consider absolute numeric entries, changes in key ratios, and any other changes indicative of a change in financial activities. The analysis should be based on expenses that vary with changes in production or volume of sales.
  - b. The analysis should include all schedules that report financial activity, including Schedules C, D, E, and F.
  - c. The analysis can be documented by notes on the CDE prints, or a prepared schedule.
  - d. This analysis should be completed in conjunction with the Required Filing Checks under IRM 4.10.5.3, Prior and Subsequent Year Returns.
  - e. Significant variations (5 percent or more) suggest changes in business or reporting practices that need to be discussed with the taxpayer.
  - f. See *Example - Horizontal Analysis – Cost of Goods Sold Analysis*.
- (4) Vertical Analysis - This analysis identifies differences between the taxpayer's business and the industry standards for a given year and is an indicator of the reasonableness of gross receipts and net profit reported on the tax return. Ask the taxpayer what the gross profit should be and test the gross profit percentage by tracing specific transactions from the purchase of a product for resale to the sale of the item. Industry standards can be found at *BizStats*. See IRM 4.10.4.2.3.8 for complete discussion and examples.

**Note:** Bizstats industry standards data is available for one year. It is generally available for the third year from the current calendar year (i.e., for calendar year 2023, data is available for 2020).

- a. Expenses are expressed as a percentage of gross receipts.
  - b. Potential underreporting of income which equals 10 percent or more of the reported income should be resolved with the taxpayer's assistance. Discrepancies can be caused by errors in reporting gross receipts, inventory, or purchases. See IRM 4.10.3.11.1, Gross Profit Ratio Test, paragraphs 12, 13, and 14 for lists of possible errors.
  - c. A comparison against industry norms alone, which indicates a discrepancy, is not justification for using a formal indirect method to make the actual determination of tax liability unless the taxpayer is uncooperative or nonresponsive.
  - d. See *Job Aid - Vertical Analysis - Cost of Goods Sold to Sales Ratio* for an example.
- (5) Examiners are not limited to the ratio demonstrated above. Any ratio or standard available for the taxpayer's industry can be used for the analysis. See IRM 4.10.3.11.1.

**Example:** The taxpayer is the sole proprietor of a bar. The examiner reviews the taxpayer's books and records, and tests the gross receipts as a percentage of purchases. The taxpayer states that the markup percentage is approximately 150 percent, which the examiner knows is consistent with industry practices. However, the examiner determines that the actual markup percentage is 100 percent. Based on the taxpayer's oral testimony and the industry practice, it appears that the taxpayer may not be reporting all of the gross receipts.

**Example:** The taxpayer sells pianos. The examiner selected a sample of four actual purchases and subsequent sales by the taxpayer; the average markup for the four piano sales was 51.7 percent. Overall, for the

business as reported on Schedule C, the markup is 27 percent. Based on the comparison, it appears that the taxpayer may not be reporting all of the gross receipts.

4.10.4.2.3.9  
(05-27-2011)  
**E-Commerce**

- (1) More information on e-commerce income issues can be found in IRM 4.10.4.2.7.1.

4.10.4.2.3.10  
(05-27-2011)  
**Deviation on Individual  
Business Returns  
Minimum Income Probes**

- (1) Examiners may find that one or more of the minimum income probes cannot be performed in a particular case or that no value is added by performing a specific minimum income probe. The decision to deviate from one or more of the minimum income probe requirements must be based on the specific facts of the case as they relate to the taxpayer.
- (2) When the examiner determines a deviation from a minimum income probe is warranted, the reason(s) must be documented in the appropriate minimum income probe workpapers. The factors considered and rationale for deviating must be specifically documented. The documentation must clearly support the decision.

**Caution:** This section cannot be used to deviate or otherwise limit the minimum income probes due to workload or other factors not related to the taxpayer.

4.10.4.2.4  
(05-27-2011)  
**Minimum Income  
Probes: Corporations  
and Other “Business”  
Returns**

- (1) **Balance Sheet** - Prepare a Balance Sheet Analysis. See IRM 4.10.4.2.4.1.
- (2) **Reconciliation** - Reconcile Schedules M-1, M-2, and M-3. See IRM 4.10.4.2.4.2.
- (3) **Shareholder and Partners** - Evaluate the tax returns of significant shareholders or partners. See IRM 4.10.4.2.4.3.
- (4) **Interview** - Interview the taxpayer. See IRM 4.10.4.2.4.4.
- (5) **Tour of Business** - Perform a tour of the business site. See IRM 4.10.4.2.4.5.
- (6) **Internal Controls** - Evaluate the internal controls. See IRM 4.10.4.2.4.6.
- (7) **Gross Receipts** - Test gross receipts or sales. See IRM 4.10.4.2.4.7.
- (8) **Ratio Analysis** - Prepare a business ratio analysis. See IRM 4.10.4.2.4.8.
- (9) **E-Commerce and/or Internet Use** - Determine if there are internet use and e-commerce income activity. See IRM 4.10.4.2.3.9.

4.10.4.2.4.1  
(08-09-2011)  
**Balance Sheet Analysis  
(Corporations and Other  
“Business” Returns)**

- (1) Prepare an analysis of the balance sheet and tax return information. The purpose of the analysis is to assist in the identification of issues to be examined.
- (2) Significant changes to any accounts should be noted and resolved during the examination.
  - a. Analyze significant balance sheet accounts which show substantial increases or decreases that may indicate the misclassification of income and accounts. IRM 4.10.3.10.4, Step 3: In-Depth Analysis, includes guidance for specific balance sheet accounts.

- b. Entries that reduce taxable income, such as a deferral or postponed recognition of income should be examined. A deferred income account (typically included in the liability section of the balance sheet), may indicate income from services performed or merchandise shipped and received by the customer. A deferral of income is not proper in these cases. Additional examples include “loans to shareholders,” suspense accounts, and reserve accounts.
- c. Cash accounts should always be analyzed to identify unusual transactions (i.e., transactions that are not part of the day-to-day operations, and transactions involving shareholders, partners, or employees). Review all adjusting entries. Compare year-end bank reconciliation to the books for all cash accounts. Review the cash receipts journal for any items that are not credits to income or accounts receivable. Look for entries from sources other than cash receipts or disbursements which may indicate unauthorized withdrawals or expenditures, the acquisition or disposition on an asset, omitted income, or undisclosed bank/financial accounts.
- d. Notes and accounts receivable should be identified (beginning and ending balances); tie the general ledger to the subsidiary ledger. Credit balances may indicate additional income or unrecorded sales. Old receivables, where no legal or collection action has taken place, should also be reviewed. The receivable may have been paid directly to a shareholder, partner or employee and left on the books.
- e. Review inventory sheets and identify how the inventory value was determined (Cost or Market, Last In, First-Out (LIFO) or First-In, First-Out (FIFO). Ending inventory can be manipulated to control new profit. Look for write-downs, review items valued at \$0, and trace values back to purchase invoices.
- f. Loans to shareholders should be analyzed to ensure entries to this account are not distributions of earnings, dividend income, or another form of taxable income reportable by the shareholder. If no interest is paid, consider imputing interest at the current rate. If no repayments have been made, consider whether the debt has been forgiven.
- g. Buildings and other depreciable assets should be reviewed to verify additions and deletions. How was a purchase financed? Could the asset be for personal use? If assets are removed from the balance sheet, how did the disposition occur? Was the disposition accounted for? Assets may remain on the balance sheet, even if disposed of.
- h. Accounts payable should be identified (beginning and ending balances); tie the trial balance to the general ledger; check for adjusting entries, netting of related accounts receivable, or reclassifications that may be unreported income or understatement of sales. Review taxpayer’s policies for making payments; deviations should be reviewed. The majority of accounts payable should be inventory purchases; when the value of the account payable is similar to or greater than inventory, there may be a misstatement of ending Inventory.
- i. Analyze the loans from shareholder account (beginning and ending balances), which may be consolidated with other accounts. Consider the possibility that diverted corporate income was lent back to the corporation. Make sure the transactions reflects a bona fide loan and loan repayments; there should be a loan instrument with terms and stated interest rate. Does the shareholder have the means to loan the money to the entity? If not, what was the source of funds? Consider whether the loan is a capital contribution and if the interest paid to the shareholder is really a dividend. Loans from financial institutions to the taxpayer, where the shareholder

cosigned or guaranteed the debt, are not loans from shareholders; these loans should be included in Notes Payable.

- j. The retained earnings account should be analyzed, including all adjustments and adjusting entries. Make sure the reasons for the adjustments are understood. Entries that are debited or credited to retained earnings have no effect on the profit and loss statement for the current year. Also review Schedules M-1 and M-2 and make sure items such as meals and entertainment, book versus tax depreciation, penalties, etc. are accounted for and that no item with potential tax impact is incorrectly included in retained earnings rather than addressed on the tax return.

- (3) Review the corporate minutes to evaluate potential for accumulated earning tax under IRC 531, Imposition of accumulated earnings tax. Corporations must have a business reason for accumulating earnings in excess of \$250,000; otherwise, earnings should be distributed to shareholders as dividends. Review the dividend history to determine when (if ever) dividends were issued. If the business is consistently profitable and no dividends have been distributed to the shareholder, the shareholder's compensation may be unreasonably high.
- (4) Use CFOL information or secure copies of subsequent and prior year returns from the taxpayer to complete the comparative analysis when the examination is initiated.
- (5) Tie balance sheet accounts, such as cash, to their respective source documents (cash receipt/disbursement journals and bank reconciliations).
- (6) Tie balance sheet accounts such as accounts receivable and accounts payable to the receivable/payable subsidiary ledger ending balance.
- (7) Compare the adjusted trial balance to the balance sheet to ensure they match. Account grouping sheets should be requested for this analysis. This is an essential step in the examination of a double-entry set of books.
- (8) Review the adjusting journal entries from the unadjusted trial balance to the adjusted trial balance for misclassifications, unusual debits to income accounts or possible manipulations of reported income. The adjusted trial balance should be tied to the general ledger to ensure there are no missing adjusting journal entries.
- (9) The general ledger should be scanned for large, unusual or questionable items in the journal entries or adjusting journal entries, such as debit entries to income accounts or credit entries to asset accounts (i.e., accounts receivable that do not flow from the cash receipts journal).
- (10) See IRM 4.10.3.10, Balance Sheet Analysis: Introduction, for additional instructions.

4.10.4.2.4.2  
(08-09-2011)

**Schedules M-1, M-2, and  
M-3 (Corporations and  
Other "Business"  
Returns)**

- (1) Perform a reconciliation of Schedule M-1, Reconciliation of Income/Loss Per Books with Income Per Return, or equivalent schedule.
  - a. The entries on Schedule M-1 are not part of the taxpayer's double-entry account system. Normal accounting controls do not exist; and, therefore, errors can be frequent. Look for items that are deducted from the books and then again (erroneously) on the Schedule M-1; transpositions of numbers; an expense on the books but not on the tax return.



- b. The taxpayer may disguise its Schedule M-1 adjustments by combining or netting items which normally are reported as separate line items.
  - c. Omitted Schedule M-1 items can be found by analyzing balance sheet accounts (especially liabilities), which are not affected by Schedule M-1 adjustments on the tax return.
  - d. See IRM 4.10.3.8.1, Schedule M-1, for a complete discussion and example.
- (2) Perform a reconciliation of Schedule M-2, Analysis of Unappropriated Retained Earnings per Books, or equivalent schedule. The disposition of, or changes to, retained earnings can indicate whether monies have been distributed to a shareholder and where those funds originated. Refer to IRM 4.10.3.8.2, Schedule M-2, for complete discussion.
- (3) Perform a reconciliation of Schedule M-3.
- a. Schedule M-3, Net Income (Loss) Reconciliation for Corporations with Total Assets of \$10 Million or More, is used by corporations filing Form 1120, U.S. Corporation Income Tax Return, whose total assets on Schedule L, Line 15, column (d) equal \$10 million or more for taxable years ending on or after December 31, 2004. For tax years ending on or after December 31, 2006, the filing requirement is expanded to include taxpayers with total assets of \$10 million or more and who file Form 1120-S, Form 1120-L, U.S. Life Insurance Company Income Tax Return, or Form 1120-PC, U.S. Property and Casualty Insurance Company Income Tax Return.
  - b. Part I primarily reconciles financial statement worldwide net income (loss) for the corporation (or consolidated financial statement group, if applicable) to net income (loss) per the income statement of the corporation for U.S. taxable income purposes. Parts II and III reconcile financial statement net income (loss) for the U.S. corporation (or consolidated tax group, if applicable) to taxable income reported on Form 1120. Part II generally reflects income, gain and loss items. Part III generally reflects expense and deduction items.
  - c. A partnership is required to file Schedule M-3, Net Income (Loss) Reconciliation for Certain Partnerships, if it has \$10 million or more in assets at the end of the year, \$35 million or more in total receipts, or is 50 percent or more owned by a taxpayer.

4.10.4.2.4.3  
(08-09-2011)

**Required Filing Checks  
(Corporations and Other  
"Business" Returns)**

- (1) Corporate and stockholder returns, as well as partnership and the associated partner returns, are considered related because the returns are for entities over which the taxpayer (stockholder or partner) has control and which can be manipulated to divert funds or camouflage transactions. Evaluate copies of the tax returns of significant shareholders or partners (greater than 20 percent direct or indirect ownership) for:
- a. Examination potential (including issues unrelated to the corporate or partnership return),
  - b. The proper treatment of related transactions with the corporation or partnership, including losses from related parties, and
  - c. The likelihood of diverted funds.
- (2) See *Job Aid - Tax Treatment of Diverted Income* if funds diverted from a corporation to a stockholder are identified.

- (3) Completion of the Required Filing Checks is not a violation of IRC 7602(e). See IRM 4.10.5, Required Filing Checks.
- (4) Copies of related shareholder/partner returns should be obtained using CFOL or CDE first. If the CFOL and CDE information is insufficient, the return should be requested from either the campus or the taxpayer for inspection. See IRM 4.10.5.2.2, Internal Sources of Information.
- (5) For cases in which entities related through a flow-through relationship are suspected, but cannot be otherwise identified, examiners should request research using the *yK1 Link Analysis Tool*. This tool provides a graphic representation of flow-through relationships created by partnerships, trusts, and S corporations. The tool uses Schedule K-1 data to depict ownership relationships and income/loss flows between payers and payees.
- (6) Examiners should determine if the income from the related business entity was included on the shareholder/partner's individual return. If the income was reported and there are no other issues, the return should not be opened for examination. If the income from the related business entity was not reported on the return, the examiner should open the shareholder/partner's individual return for audit. For example, the business did not issue Form W-2 to corporate officers. See IRM 4.10.5.4, Related and Spin-Off Returns.
- (7) Independent of the potential underreported income from the business entity, the return should be opened for audit if the examiner notes that a financial status analysis based solely on the return indicates insufficient funds to support the identified expenses, or a large, unusual, or questionable item is identified.
- (8) Examiners should determine whether the related return warrants examination from a classification perspective (i.e., trace the transactions between the individual and related business entity, complete a financial status analysis based on the return as filed and internal sources of information (*Job Aid - Internal Sources of Information*), and review the return for other potential issues).
- (9) Should the related individual return be opened for audit, it is subject to the minimum income probes and examiners are expected to determine whether the taxpayer has reported the correct amount of taxable income. The depth of the examination of income and the techniques used are dependent on the facts and circumstances of the case.

**Example:** A closely held corporation was examined. The 100 percent shareholder's personal expenses were deducted as a business expense on the corporate return. The shareholder's personal return was examined to make the adjustment for the unreported dividend. A reasonable likelihood of unreported income on the shareholder's return exists because the shareholder has manipulated the corporate entity and camouflaged non-deductible personal expenses as deductible business expenses. The examiner should go beyond the minimum income probes for this related shareholder, since there is a reasonable likelihood of unreported income on the individual return.



4.10.4.2.4.4  
(08-09-2011)

**Initial Interview  
(Corporations and Other  
“Business” Returns)**

- (1) The initial interview should be held with the partnership’s general partner, managing member if an LLC, Tax Matters Partner (TMP) if a TEFRA entity, or the corporate officer most familiar with the day-to-day operations of the business. From the taxpayer’s perspective, an interview with an Internal Revenue examiner may be overwhelming. Therefore, initial interviews should be professional and not overbearing.
- (2) Bartering income should be considered.
- (3) IRC 7521(c) states that examiners cannot require a taxpayer to accompany an authorized representative to an examination interview in the absence of an administrative summons. However, the taxpayer’s voluntary presence can be requested through the representative. Should an examiner find that a representative has unreasonably delayed or hindered an examination, an examiner can bypass the representative and deal directly with the taxpayer. See , as outlined in IRM 4.11.55.4, By-Pass of a Representative..
- (4) Question the TMP, corporate officer, or representative concerning possible loans, gifts, or other nontaxable funds, known errors/omissions on the return, unreported sources of income and ask for any information necessary to resolve issues identified during the pre-audit analysis. If loan proceeds are identified, request the loan application documents to validate that financial reporting is consistent with the tax return. Discrepancies should be resolved with the taxpayer’s assistance.
- (5) Question the TMP, corporate officer, or representative about cash-on-hand and accumulated funds. See IRM 4.10.4.2.3.2, IRM 4.10.4.5.8.3, and see *Interview Questions - Addressing Accumulated Funds*.
- (6) Question the TMP, corporate officer, or representative about e-commerce activities. See *Interview Questions - Addressing E-Commerce Activities*.
- (7) Question the TMP, corporate officer or representative about internal controls, including the segregation of duties, which can be verified during the audit. The flow of money should be established to determine any potential control weaknesses which could result in diversion of funds.
- (8) Refer to IRM 4.10.3, Examination Techniques, and IRM 4.10.4.2.3.2 for additional interview questions. Although these questions are intended for individual business returns, they are equally applicable to other business entities.
- (9) IRC 7521(b)(2) requires examiners to suspend interviews when taxpayers state that they wish to consult with a representative or otherwise seek advice. The taxpayer’s right of consultation will be strictly honored and interviews will be suspended and rescheduled accordingly. This provision does not apply to interviews initiated by administrative summons and will not be used to repeatedly delay or hinder the examination process.

4.10.4.2.4.5  
(08-09-2011)

**Tour of Business Sites  
(Corporations and Other  
“Business” Returns)**

- (1) Conduct a tour of the physical business site controlled by the taxpayer. Generally, the physical business site will be the principal location and any other locations acquired during the period under examination should be visited (see IRM 4.10.4.2.3.3). The purpose of a tour is to:
  - a. Gain familiarity with the taxpayer’s business operation and internal controls,
  - b. Identify potential sources of unreported income, and

c. Confirm the existence of assets.

- (2) A tour of the physical business site is not required for office audit cases. However, if appropriate (and with manager's approval), a tour of the business site may be conducted.
- (3) The results of a tour and any observations should be documented in the examination workpapers.
- (4) Conduct a tour of the business websites controlled by the taxpayer. See IRM 4.10.4.2.7.2.

4.10.4.2.4.6  
(08-29-2025)

**Evaluate Internal Controls (Corporations and Other "Business" Returns)**

- (1) Internal controls are the taxpayer's policies and procedures to identify, measure and safeguard business operations and avoid material misstatements of financial information. Evaluate the internal controls to gain an understanding of the taxpayer's business operations and control features. See IRM 4.10.3.6, Evaluating the Taxpayer's Internal Controls. If the taxpayer maintains electronic books and records, refer to IRM 4.10.4.2.7.5.
- (2) While there is no exhaustive definition of weak internal accounting controls, which will impact the scope of the examination of income, examples include:
  - a. Books and records that cannot be reconciled to the tax return
  - b. Transactions that are not properly authorized
  - c. Recorded transactions are not valid
  - d. Existing transactions are not recorded
  - e. Transactions are improperly valued
  - f. Transactions are improperly classified
  - g. Transaction are recorded at the improper time
  - h. Transactions are incorrectly summarized
  - i. Transactions all made by the same person or related parties
  - j. Recording and handling of assets by the same person or related parties
  - k. Income is diverted from the corporation or other business entity to a stockholder or other related entity
- (3) If it is determined that the internal controls are weak, identify when and how income could be diverted.
  - a. Cash receipts could be skimmed if the sole shareholder makes all the deposits.
  - b. A large number of over-aged receivables or bad debts, where no debt collection agency is involved, may indicate that payments on account are being diverted by a shareholder.
  - c. Secondary sources of income (such as video arcade games or vending machines) that are not accounted for in the books and records are indicative of unreported income. See *Example - Evaluation of Internal Controls*.
- (4) The workpapers must document:
  - a. The conclusions reached by the analysis of internal controls,
  - b. The impact on the scope of the examination, and
  - c. The impact on the depth of the examination of income.

4.10.4.2.4.7  
(08-09-2011)

**Test Gross Business Receipts or Sales (Corporations and Other “Business” Returns)**

- (1) Analyze the information obtained in the initial interview, observed during the tour of the business site, and from the evaluation of the internal controls to gain a complete understanding of the taxpayer’s business operations and control features.
- (2) Reconcile the bank records. The depth of bank record inspection will depend on the reliability of internal controls and the judgment of the examiner. See IRM 4.10.4.2.4.6, Evaluate Internal Controls (Corporations and Other **Business** Returns), for complete discussion. In addition, consider the results of the analysis of the primary shareholders’ or partners’ individual returns. The initial IDR may include a request for the business bank/financial records, including the statements, deposit slips and cancelled checks. See IRM 4.10.3.9, Bank Record Reconciliations.
- (3) See IRM 4.10.3.11, Testing Gross Receipts or Sales, for a complete discussion and listing of audit techniques.
- (4) See IRM 4.10.4.2.7.4, Identifying Gross Business Receipts from E-commerce Activities.

4.10.4.2.4.8  
(08-09-2011)

**Business Ratio Analyses (Corporations and Other “Business” Returns)**

- (1) The taxpayer’s books and records can be used to evaluate the accuracy and reasonableness of the reported income through the use of ratios. A horizontal analysis, with documented conclusions, should be included in the case file for all business returns. A vertical analysis may not be appropriate for every case.
- (2) **Horizontal Analysis** - This analysis identifies changes over time and may result in the identification of LUQ items not readily identified from a review of a single tax return. The tax return under audit should be compared to the prior and subsequent year returns. See IRM 4.10.4.2.3.8 for complete discussion and examples.
- (3) **Vertical Analysis** - This analysis identifies differences between the taxpayer’s business and industry standards for a given year and is an indicator of the reasonableness of gross business receipts and net profit reported on the tax return. A vertical analysis may not be appropriate for every case. Industry standards can be found at *Bizstats*. See IRM 4.10.4.2.3.8 for complete discussion and examples.

**Note:** Bizstats industry standards data is available for one year. It is generally available for the third year from the current calendar year (i.e., for calendar year 2023, data is available for 2020).

4.10.4.2.4.9  
(05-27-2011)

**E-Commerce**

- (1) Refer to IRM 4.10.4.2.7.1 for additional information on e-commerce income issues.

4.10.4.2.4.10  
(05-27-2011)

**Deviation on Corporations and Other Business Returns Minimum Income Probes**

- (1) Examiners may find that one or more of the minimum income probes cannot be performed in a particular case or that no value is added by performing a specific minimum income probe. The decision to deviate from one or more of the minimum income probe requirements must be based on the specific facts of the case as they relate to the taxpayer.
- (2) When the examiner determines a deviation from a minimum income probe is warranted, the reason(s) must be documented in the appropriate minimum

income probe workpapers. The factors considered and rationale for deviating must be specifically documented. The documentation must clearly support the decision.

**Caution:** This section cannot be used to deviate or otherwise limit the minimum income probes due to workload or other factors not related to the taxpayer.

4.10.4.2.5  
(08-09-2011)  
**Minimum Income  
Probes: Delinquent  
Filed Returns and  
Nonfiled Returns**

- (1) Delinquent returns filed at a campus or with an examiner are subject to the same minimum requirements for the examination of income as timely filed returns.
- (2) If a financial status analysis (or another analysis) based on a return secured from a nonfiler as part of an examination indicates that there is a likelihood of unreported income, then an in-depth examination of income should be conducted and a formal indirect method is used to make the actual determination of tax liability if warranted.
- (3) Refer to IRM 4.12.1, Nonfiled Returns, for more information.
- (4) Substitutes for return(s) filed on behalf of a nonfiler under IRC 6020(b), Execution of return by secretary, will require a reconstruction and examination of income.
  - a. Secure and review available internal information to use in the determination of the scope of examination of income. See *Job Aid - Internal Sources of Information*. If income is identified through IRP, it may be necessary to contact third parties to verify income items reported on a *Form 1099* or *Form W-2* if the taxpayer disputes the income items reported. The IRC 7602(c), Notice of contact of third parties, requirement to provide the taxpayer with notice of third party contacts applies.

**Note:** Refer to IRC 6201, Assessment authority, and IRM 4.10.4.2.6.1 below for when third party contact for verification is legally required, and IRM 4.10.7.6.1.2, Relationship with IRC section 6201(d) for steps that should be taken if the taxpayer disputes IRP income.

- b. Business expenses should be determined using the taxpayer's books and records. In the event the taxpayer cannot substantiate business expenses, the IRS has no legal requirement to estimate expenses. Estimates may be used if the taxpayer can provide a reasonable basis. For example, the taxpayer can substantiate business expenses in another year and establishes that the nature of the business was the same as for the year under audit.
- c. If the sale of securities (stock, bond, etc.) is an issue, the IRS has no legal requirement to obtain basis information from third party sources, despite the fact that the proceeds of such sales are included in income.
- d. Use BLS information (or comparable statistics from a reliable source) to estimate personal living expenses. See IRM 4.10.4.2.3.1 and IRM 4.10.4.5.1.3.1.
- e. Use industry ratios (available at *Bizstats*) to evaluate the reasonableness of the nonfiler's records of gross income.

**Note:** Bizstats industry standards data is available for one year. It is generally available for the third year from the current calendar year (i. e., for calendar year 2023, data is available for 2020).

- f. Only the standard deduction should be allowed as the use of itemized deductions is an election by the taxpayer. However, IRP or other information about deductible personal living expenses should be included in the financial status analysis.
- (5) Examiners should attempt to use the nonfiler's books and records to prepare a preliminary schedule of gross income. Based upon the evaluation of the nonfiler's schedule of gross income, available internal information, and statistical information, the examiner must determine the subsequent audit scope using the following criteria:

IF	THEN
The nonfiler's schedule of gross income prepared from his/her books and records is consistent with all financial activities of the nonfiler and available internal information.	The substitute for return may be prepared using the nonfiler's record of gross income. The results and conclusions reached should be documented in the examination workpapers.
The nonfiler's schedule of gross income prepared from his/her books and records is inconsistent with the financial activities of the nonfiler and/or available information.	A more in-depth examination of income is warranted. See IRM 4.10.4.4 below for suggested elements of an in-depth examination income for an individual nonfiler. <b>Note:</b> Collectibility consideration should be given to each situation in which the examination scope may be expanded.

4.10.4.2.6  
(05-27-2011)

**Minimum Income**

**Probes: No Show and/or  
No Response Cases**

- (1) All examinations, including no show/no response cases, must address the minimum income probes required by this IRM, including a T-Account.
- (2) A no show occurs when a "deliverable" address exists, but the taxpayer does not respond to the correspondence or does not "show" for any scheduled appointment. Follow-up attempts must be made to contact the taxpayer to encourage him/her to schedule and keep an appointment or to solicit an agreement.
- If all attempts to get the taxpayer to respond are unsuccessful (or the taxpayer raises a frivolous dispute) and minimum income probes have been completed, a report may be issued if income is not an issue.
  - If income is an issue, the examiner must conduct research and resolve the income issue before preparing the report.

**Note:** When a report is prepared, generally, only classified issues will be disallowed. If certain issues were declassified at the group level due to time constraints, these items should be disallowed as well. All the necessary

related or automatic adjustments will be made. Consideration will be given to picking up prior and subsequent years.

- (3) No response occurs when a taxpayer fails to respond to the initial contact letter or telephone call. The field and office examiner must determine why the taxpayer is not responding:
- The examiner must follow the procedures in IRM 4.10.2.8.1.2, Field Examination Initial Contact, paragraphs 7 and 8.
  - If the initial appointment letter has been returned undeliverable, the examiner must follow the steps in IRM 4.10.2.7.2, Locating the Taxpayer, to secure a current address or telephone number. If unsuccessful, the mandatory steps in IRM 4.10.2.8.3, No Response/No Show Procedures, must be taken and documented on Form 1900-B, Unlocatable Taxpayer Check Sheet.
  - If the steps above do not result in a current address for the taxpayer, ensure the minimum income probes listed below have been conducted, and income is not an issue. The examiner and group manager must consider whether an audit report is appropriate when the taxpayer cannot be located using the criteria in IRM 4.10.2.8.6, Case Closing Procedures if the Taxpayer Cannot Be Located.
  - If a decision is made to issue a report, disallow all classified issues only, consider prior and subsequent years, and mail it to the taxpayer's last known address as reflected on IDRS. See IRM 4.10.2.8.4, Undeliverable Initial Contact Letters.

**Note:** Cases where the taxpayer fails to respond to the initial contact letter or telephone call are not classifiable as no-contact, therefore they may not be surveyed. See IRM 4.10.2.10.1, Confirmation of the Initial Appointment. If an assessment is not appropriate, the case should be closed using Non-examined Disposal Code 42, Return Filed - Unable to locate. Form 1900, Income Tax Survey, should be completed. The examiner should also document steps taken to locate the taxpayer on Form 1900-B, Unlocatable Taxpayer Checksheet, in the workpapers.

4.10.4.2.6.1  
(05-27-2011)  
**Minimum Income Probes  
Used by Examiners**

- (1) Income probes for no show/no response cases may also include specific items or indirect methods to determine whether the taxpayer accurately reported income.

4.10.4.2.6.2  
(08-09-2011)  
**Specific Item Probes  
Using Information  
Returns Program (IRP)  
Cases**

- (1) When using the specific item method for adjustments based on unreported IRP income, if the taxpayer fails to respond or raise a "reasonable dispute" regarding the correctness of the IRP data, then the burden of proof remains with the taxpayer and does not shift to the government. In unreported income cases based on IRP information, there is no legal requirement pursuant to IRC 6201(d), Required reasonable verification of information returns, to contact third parties to verify income items unless the taxpayer reasonably disputes the income and has fully cooperated with the IRS.
- (2) In no show/no response cases where the taxpayer has not responded or raised a frivolous dispute (wages are not income, etc.), there is no legal requirement for further verification with third parties and an income adjustment in the amount reflected on the IRP document is appropriate. Verification with third



parties is required when IRP information is relied upon to support the civil fraud penalty (IRC 6663, Imposition of fraud penalty) or where the taxpayer disputes the IRP income information.

- (3) Verification with third parties should also be made in no show/no response cases where there is an inconsistency noted in the file that would cause the examiner to question the validity of the IRP information.

**Example:** Verification of income should be attempted if there is some obvious inconsistency in the IRP information (such as *Form 1099* or *Form W-2*) that appears to be out of line in dollar amount from previous years, or there is some aspect of the *Form 1099* or *Form W-2* that is unusual on its face (such as *Form 1099* or *Form W-2* income that is completely inconsistent with the known profession or occupation of the taxpayer).

- (4) In cases involving large dollar income items (e.g., *Form 1099-NEC*, Nonemployee Compensation, or *Form 1099-MISC*, Miscellaneous Information, amounts greater than \$100,000), examiners, in consultation with their manager, should use their professional judgment in deciding whether it makes good business sense (given the circumstances) to verify IRP information. This discussion should be documented in the workpapers.

4.10.4.2.6.3  
(05-27-2011)  
**Indirect Methods in  
Which the Preliminary  
T-Account Has a  
Material Imbalance:**

- (1) If an indirect method is used, the use of statistical data must be tailored to the individual taxpayer.
- (2) If an indirect method reveals an understatement of income in excess of \$10,000 and the case is a no show, the examiner must take the following steps:
  - a. Examiners must use all available administrative tools, including summons enforcement, to gather necessary information before statistical data is used.
  - b. If a T-Account is used, do not reduce the expense side for disallowed expenses. Assume (even though disallowed) that the taxpayer spent the money.
  - c. Refer to IRM 4.10.4.5.1.3, Use of Bureau of Labor Statistics Data or Other Statistical Information to Reconstruct Taxable Income, to determine when income may be reconstructed using BLS data or comparable statistics from a reliable source. The analysis is completed using the tables for annual expenses, not income, because determining the expenses represents a better reflection of the actual costs to maintain a household.
  - d. The examiner and manager must determine if an income adjustment will be pursued based on the information contained in the indirect method, and if so, document it in the case file.
  - e. Prior and subsequent year's returns should be considered for similar imbalances.
  - f. For TCO cases, discuss with the manager whether the case warrants transfer to the field. This would include any cases that are beyond the scope of an office audit for reasons such as the complexity of the issues or complexity of additional related businesses such as flow-through entities. See IRM 4.11.29, Transfer of Returns Open for Examination.

4.10.4.2.6.4  
(05-27-2011)

**Estimated Business Expenses**

- (1) In no show/no response cases the IRS has no legal requirement to estimate expenses, including cost of goods sold. If the examiner has actual taxpayer information regarding expenses, then taxpayer specific information (not industry averages) should be used to determine expenses.
- (2) If the sale of securities is an issue and in cases where the taxpayer has not substantiated stock basis, the IRS has no legal requirement to obtain basis information from third party sources, despite the fact that the proceeds of stock sales are included in income.

4.10.4.2.6.5  
(08-09-2011)

**Penalties Application**

- (1) Penalties, such as negligence, will not be asserted solely due to the taxpayer's failure to appear for an audit or respond to an inquiry or notice. However, the facts and circumstances from the return and the case file may warrant assertion of the accuracy-related penalty attributable to negligence.
- (2) See IRM 20.1.5.8.1, Negligence, and IRM 20.1.5.9, IRC 6662(d) and IRC 6662(b)(2), Substantial Understatement, paragraph 6. The examiner should document actions and decisions using Form 9984, Examining Officer's Activity Record.

4.10.4.2.7  
(08-29-2025)

**Minimum Income Probes: E-Commerce Income**

- (1) Electronic commerce (e-commerce) includes a wide range of business activities transacted over computer networks and the internet. This section outlines audit techniques for addressing e-commerce during the minimum income probes.
- (2) Internet research is a powerful technique for gathering information about individuals and businesses. Most information on the internet is freely available; however, there are also websites that charge a usage or subscription fee. Finding information about a taxpayer by searching the internet requires knowledge of the available tools. Examiners may need to discover who owns a website or contact third parties to obtain information about a website. Additionally, examiners must adhere to the guidance in IRM 10.8.1, Policy and Guidance, and IRM 11.3.21.12, Internet Research, when conducting internet research.

**Caution:** IRS employees are not authorized to log in to social media in an official capacity. Social media encompasses internet forums, blogs, wikis, podcasts, and picture or video sharing. See IRM 11.3.21.12.1, IRC 6103(k)(6) Disclosures by IRS Employees Using Social Networking and Other Internet Sites, for more information.

- (3) You can use the internet to help you do the following:
  - Locate taxpayers or their assets and verify mailing addresses.
  - Understand various types of businesses.
  - Confirm/validate the information taxpayers provide.
  - Identify forms of payment accepted by businesses (e.g., PayPal®, Venmo®, CashApp®, Zelle®, virtual currency, Visa®, MasterCard®, American Express®, etc.)

4.10.4.2.7.1  
(08-09-2011)

**Identifying E-Commerce Businesses**

- (1) Determining whether a taxpayer uses the internet can be done during any phase of the examination. However, if it can be identified, the website should be reviewed during the pre-contact stage.
- (2) Some items for examiners to consider when researching the internet include:



- a. The business name. The business name maybe included in an internet domain name (i.e., “mycompany.com”).
  - b. The taxpayer’s name, business name, or phone number using a search engine such as Google®, Bing®, or Yahoo® to determine whether the taxpayer has web page listings. Be alert for multiple listings.
  - c. Look for deductions on the return that are common to e-commerce businesses, such as depreciation for networking equipment or high telecommunications expenditures, or payments to an Internet Service Provider (ISP) or an Application Service Provider (ASP).
  - d. Business cards for website reference. Generally, business cards will include a website address, if one is available.
  - e. Advertisements (e.g., the “Yellow Pages”) may include an internet address for the business.
- (3) In every case, examiners should search for an internet presence using a search engine such as Google. Examiners should also ask the taxpayer about internet use. Effective web searching provides tips on using the advanced search features of popular search engines to narrow results. Internet use and e-commerce activities provide examples of appropriate open-ended questions.

4.10.4.2.7.2  
(05-27-2011)  
**Reviewing Websites**

- (1) If a website is discovered, viewing it can provide insight into the taxpayer’s activities. Reviewing a taxpayer’s website is a complement to touring the physical business site (e.g., to gather information helpful to understanding the business activities).
- (2) To see how the website looked in the year under audit, search the *Internet Archive*. The search feature is called the “Wayback Machine.” The examiner will be provided with a historical copy of all available archived copies of the website.
- (3) Evidence of an unreported e-business activity can be found by reconciling credit card payments, as a taxpayer may consolidate all credit card or payment vouchers when submitting them to the e-payment provider.
- (4) When reviewing a website, consider the following questions:
  - a. What purpose does the website serve? Some websites are used as advertisement or for information sharing with no elements of e-commerce.
  - b. Is there a unique term that the taxpayer uses to advertise the site? If so, an internet search may identify additional websites or business operations.
  - c. Does the website provide information about the business? Often, there will be an “About Us” page with information about officers, owners and key employees.
  - d. Does it provide information on how to contact the business?
  - e. Does the business gather information about its customers on the website? Would a customer need a password to sign in?
  - f. Are goods and/or services sold on the website?
  - g. Can purchases be processed through the website?
  - h. What methods of payments are accepted?
  - i. Does the website include links to other websites controlled by the taxpayer? Links, banners, and pop-up windows may provide information about additional income from advertisements, reciprocal links to generate traffic, marketing partners, and related websites.

- j. Does the website disclose information about business partners? For example, a wholesaler in the furniture industry may furnish a list of retailers selling their product.
  - k. Is the website available in multiple languages? If so, this would indicate global markets.
- (5) Further inquiry will be needed to determine how the website is supported (i.e., whether the website is hosted by a third party or maintained on the taxpayer's own web servers, the location of the web servers, what equipment or computers are used, who has access to the servers, what records are maintained, and when the website was placed in service).
  - (6) To document the case file, save the website or make hard copies of the website pages. Documenting the website content before the taxpayer limits access may be important to the development of, or providing evidence for, an unreported income issue.

4.10.4.2.7.3  
(05-27-2011)

**Interviewing the  
Taxpayer Regarding  
E-Commerce Activities**

- (1) The taxpayer should be interviewed regarding internet use for e-commerce activities. For individual business returns, the taxpayer should be asked about both personal and business use. Payments made over the internet need to be considered as part of the minimum income probes.
- (2) *Interview Questions - Addressing E-Commerce Activities* is a list of interview questions specific to internet and website use.

4.10.4.2.7.4  
(05-27-2011)

**Identifying Gross  
Business Receipts from  
E-Commerce Activities**

- (1) This section provides an overview of common sources of taxable income generated by e-commerce activities and associated audit techniques.

4.10.4.2.7.4.1  
(08-09-2011)

**Payments for Goods and  
Services**

- (1) Generally, a business will list the types of payments accepted on the website. Review the taxpayer's web pages for payment systems and providers such as PayPal®, Visa®, MasterCard®, American Express®, Diners Club®, and real time Check Debit.
- (2) Trace these income sources through the books and records to the tax return.
- (3) Reconcile a sample of entries in the sales ledger for specific providers.
- (4) Look for providers that are not reflected in sales and verify that receipts from all payment providers are included in sales.
  - a. The taxpayer will commonly have one or more merchant accounts with a credit card processor. A "merchant account" allows a business to accept credit cards, debit cards, gift cards and other forms of electronic payment. This is also known as payment processing or credit card processing.
  - b. The taxpayer may also use payment intermediaries such as PayPal.
- (5) Evidence of unreported e-business activity can be found by reconciling daily receipts from credit cards and receipts from other electronic funds transfers to bank deposits. Such transactions are usually batched daily by both the taxpayer and the payment processor.

4.10.4.2.7.4.2  
(05-27-2011)

**Advertising Banners and  
Pop-Up Ads**

- (1) Taxpayers may receive advertising income for banner and pop-up advertisements appearing on their website. The taxpayer is being paid for advertising on another e-commerce business's products or services similar to a brick and mortar business putting up a billboard on its property and charging advertising fees.
- (2) Ask the taxpayer how this income is accounted for in the books and records.
- (3) Advertising fees may be based on the number of times the banner or pop-up ad is accessed. The site may include a counter indicating the number of visitors to the site, from which the amount of traffic on the website can be estimated. Similarly, the number of times the banner or pop-up ad is accessed can be estimated. Based on the ratio and the fee charged per access, advertising income can be estimated.
- (4) Other methods for determining the advertising fee include:
  - a. Pay-per-view is based on the activity of the website,
  - b. A fixed monthly fee, or
  - c. A commission based on sales resulting from the banner.
- (5) Taxpayers may be part of an "ad network," which is a group of websites joined together by an intermediary who sells advertising to aggregated groups of websites. This is an efficient method for advertising buyers and advertisers to reach broad audiences. Advertising income is usually collected from the intermediary.
- (6) "Ad affiliate" networks allow advertisers to trade banners. This is similar to bartering networks in which banner advertising is exchanged without any monetary compensation.

4.10.4.2.7.4.3  
(05-27-2011)

**Internet Auctions and  
Bartering**

- (1) Overstocked items and aging inventory can be liquidated by selling it on internet auction sites or exchanging it through a bartering transaction. This may be identified by unusual fluctuations in inventory.
- (2) Internet auctions and bartering can be used for on-going business activities or for disposing of assets.

4.10.4.2.7.4.4  
(05-27-2011)

**Online Sales**

- (1) Online retailers usually ship their product and shipping receipts are another record of a sale that can be reconciled with both cost of goods sold and reported gross receipts.

4.10.4.2.7.4.5  
(05-27-2011)

**Tip Jars**

- (1) A website may include a "tip jar" where cash tips may be deposited through various internet payment forms. Blogging websites have tip jars so visitors can show their appreciation, or help pay for the cost of the website.

4.10.4.2.7.4.6  
(05-27-2011)

**Customer Information**

- (1) Websites commonly gather information about the business's customers and sale of customer information can be a significant source of income. Ask the taxpayer if customer information is sold or shared, and review any formal marketing agreements.

4.10.4.2.7.5  
(08-09-2011)

**Evaluating Electronic  
Books and Records**

- (1) The Uniform Electronic Transaction Act (UETA) defines electronic records as a record created, generated, sent, communicated, received, or stored by electronic means. The UETA is suggested legislation that the National Conference of Commissioners on Uniform State Laws, in 1999, drafted and recommended be adopted by all states. More information about the UETA can be found at *Electronic Transactions Act*.
- (2) Rev. Rul. 71-20, 1971 -1 C.B. 392, establishes that all machine-sensible data media used for recording, consolidating, and summarizing accounting transactions and records within a taxpayer's Automatic Data processing (ADP) system are records within the meaning of IRC 6001, Notice or regulations requiring records, statements, and special returns, and 26 CFR 1.6001-1, Records, and are required to be retained so long as the contents may become material in the administration of any internal revenue law.
- (3) Rev. Proc. 98-25, 1998-1 C.B. 689, specifies the basic requirements that the IRS considers essential when a taxpayer maintains records within an ADP.
- (4) Rev. Proc. 98-25 provides an exemption for small business taxpayers with assets of less than \$10 million at the end of its taxable year in complying with the record retention requirements of Rev. Rul. 71-20 and Rev. Proc. 98-25. For purposes of meeting that exemption, a controlled group of corporations (as defined in IRC 1563, Definitions and special rules) is considered to be one corporation and all assets of all members of the group are aggregated. Also, a small business taxpayer will not meet the exemption provided in Rev. Proc. 98-25 if any of the following three conditions exist:
  - a. All or part of the information required by IRC 6001 is not in the taxpayer's hardcopy books and records, but is available in machine-sensible records;
  - b. Machine -sensible records were used for computations that cannot be reasonably verified or recomputed without using a computer (e.g., LIFO inventories); or
  - c. The taxpayer is notified by the IRS that machine-sensible records must be retained to meet the requirements of IRC 6001.
- (5) An "ADP System" consists of an accounting and/or financial system (and sub-systems) that processes all or part of a taxpayer's transactions, records, or data by other than manual methods. It includes, but is not limited to, a mainframe computer, stand-alone or networked microcomputer system, Data Base Management System (DBMS), and a system that uses or incorporates Electronic Data Interchange (EDI) technology or an electronic storage system. Key requirements include:
  - a. Machine-sensible records (data in an electronic format intended for use by a computer) must be retained as long as the contents may become material to the administration of the internal revenue laws. The taxpayer may enter a record retention limitation agreement with the IRS to provide for the establishment and maintenance of records as agreed upon by the IRS and the taxpayer.
  - b. Machine-sensible records must provide sufficient information to support and verify entries made on the taxpayer's return and to determine the correct tax liability (i.e., the machine-sensible records must reconcile with the taxpayer's books and the taxpayer's return, and provide an audit trail to transaction-level details in the books of original entry).

- c. Machine-sensible records must contain sufficient transaction-level detail so that the information and the source documents underlying the machine-sensible records can be identified.
  - d. All machine-sensible records required to be maintained must be made available to the IRS upon request and must be capable of being retrieved, manipulated, printed on paper, and produced as output on electronic media.
  - e. A taxpayer is not required to create any machine-sensible record other than that created either in the ordinary course of business or to establish tax return entries.
  - f. A taxpayer that used EDI technology must retain machine-sensible records that alone, or in combination with any other records, contain all the information required of hardcopy books and records. The required detail may be captured at any level within the accounting system. However, the taxpayer must establish audit trails between the retained records and books, and between the retained records and the tax return.
  - g. Taxpayers continue to be responsible for retaining hardcopy records that are created or received in the ordinary course of business. Alternatively, such records can be retained in microfiche/microfilm format (see Rev. Proc. 81-46, 1981-2 C.B. 621) or in an electronic storage system (see Rev. Proc. 97-22, 1997-1 C.B. 652).
  - h. The taxpayer must provide the IRS (at the time of examination) with the resources (e.g., appropriate hardware and software, terminal access, computer time, personnel, etc.) necessary to process machine-sensible books and records.
  - i. The taxpayer must maintain and provide (upon request) documentation of the processes that create, modify, and maintain its records. The documentation must support and verify entries made on the taxpayer's return and determine the correct tax liability, and evidence the authenticity and integrity of the taxpayer's records. Documentation includes records of internal controls that reflect: (1) the functions being performed as they relate to the flow of data through the system; (2) the internal controls used to ensure accurate and reliable processing; (3) the internal controls used to prevent the unauthorized addition, alteration, or deletion of retained records; and (4) the charts of accounts and detailed account descriptions.
- (6) Understanding the reliability of electronic books and records is critical to evaluating internal controls, reconciling the books and records to the tax return, and obtaining records. The following attributes of electronic records need to be considered when evaluating the reliability of electronic books and records:
- a. Software may include features to create a second set of books and records, or allow for manipulation of sales by reducing and/or deleting of sales transactions entirely.
  - b. Third party software programs, commonly referred to as "zapper" programs, can be used to selectively delete electronically recorded sales records. Methods or practices of deleting electronic sales records, usually cash sales are referred to as "zapping."
  - c. Electronic records are, in general, considered less reliable than their paper counterparts due to the ease with which they can be manipulated.
- (7) Rev. Proc. 97-22, 1997-1 C.B. 652, provides guidance to taxpayers that maintain books and records by using an electronic storage system that either images their hardcopy (paper) books and records or transfers their computerized books and records to an electronic storage media, such as an optical

disk, which allows books and records to be viewed or reproduced without the use of the original program. Key requirements include:

- a. Reasonable controls to ensure the integrity, accuracy, and reliability of the electronic storage system;
- b. Reasonable controls to prevent and detect the unauthorized creation of, addition to, alteration of, deletion of, or deterioration of electronically stored books and records;
- c. An inspection and quality assurance program evidenced by regular evaluations of the electronic storage system including periodic checks of electronically stored books and records;
- d. A retrieval system that includes an indexing system;
- e. The ability to reproduce legible and readable hard copies of electronically stored books and records or when displayed on a video display terminal;
- f. The information in an electronic storage system must provide support for the taxpayer's books and records; and
- g. The taxpayer must maintain and make available to the IRS upon request, a complete description of the electronic storage system, including all procedures relating to its use and the indexing system, and provide the IRS with the resources (e.g., appropriate hardware and software) necessary to locate, retrieve, read, and reproduce (including hard copies) of any electronically stored books and records.

- (8) A taxpayer is not in compliance with the recordkeeping requirements under IRC 6001 (and associated regulations) if the taxpayer's electronic storage system fails to meet the requirements of Rev. Proc. 97-22, and a Notice of Inadequate Records pursuant to 26 CFR 1.6001-1(d) should be issued. See IRM 4.10.3.19, Inadequate Records Notices: Overview.

4.10.4.2.7.6  
(05-27-2011)

#### **Third Party Record Keepers**

- (1) Banks and other financial institutions that previously maintained account information such as signature cards, loan applications, and account activity in hard copy may now do so electronically. There are online banks that only do business on the internet. Taxpayers can maintain accounts with banks across the country or even overseas, rather than with banks in close proximity to their physical location.
- (2) The internet has resulted in new third party record keepers whose information may be of help in resolving tax issues. These new third party record keepers may be able to supply information regarding website ownership, related websites owned by the taxpayer, location of the business, contact information, and the taxpayer's bank/financial accounts. Examples include:
  - a. Internet Domain Name Registrars
  - b. Internet Hosting Providers
  - c. Internet Access Provides (IAP)
  - d. Internet Service Providers (ISP)
  - e. Application Service Providers (ASP)
  - f. E-Payment Providers (e.g., PayPal)



## 4.10.4.3

(05-27-2011)

**Results of Minimum  
Income Probes**

- (1) After completion of the minimum income probes, the examiner must evaluate the information collected to this point and determine the scope of the examination of income, using the following criteria:

IF	THEN
The results show that the taxpayer reported all taxable income from known sources, the books and records can be reconciled to the tax return, all financial activities are in balance, and the bank deposits do not exceed reported income.	The examination of income may be limited to the Minimum Income Probes. The results and conclusions reached should be documented in the examination workpapers.
The results indicate the potential of unreported income due to inaccurate reporting of taxable income from known sources, the books and records cannot be reconciled to the tax return, a material imbalance in the financial status analysis that cannot be reconciled, excess unexplained bank deposits, or inadequate internal control.	A more in-depth examination of income is warranted. See IRM 4.10.4.4, in-Depth Examinations of income, for suggested guidelines for an in-depth examination of income.

## 4.10.4.3.1

(05-27-2011)

**Material  
Understatements and  
Managerial Involvement**

- (1) If the examination of income reveals an understatement of income in a given year, the case should be discussed with the group manager. The purpose of the discussion is to consider possible expansion of the examination scope/depth, audit techniques to be used, and the potential of fraudulent activity by the taxpayer.
- (2) This discussion is mandatory in any examination with an understatement of income greater than \$10,000.
- (3) This discussion should be noted on Form 9984. A summary of the content and resulting decisions should be documented in the workpapers.
- (4) Group managers should be engaged with their examiners in the development of unreported income issues. Involvement can be demonstrated by:
- Becoming familiar with the factual development and documentation,
  - Discussing cases with examiners to assist in the determination of the depth of the examination of income and the techniques that should be used,
  - Assisting examiners to determine whether the facts support the conclusion that there is a reasonable likelihood of unreported income justifying the use of a formal indirect method to make the actual determination of tax liability.
  - Issuing summonses when necessary, and
  - Contacting TIGTA immediately when a taxpayer threatens to report an RRA '98 section 1203 violation for harassment.

- (5) Management involvement should be annotated on Form 9984.

4.10.4.3.2  
(08-09-2011)  
**Inadequate Books and Records**

- (1) Whenever the taxpayer's books and records are deemed inadequate for purposes of an examination of income, the examiner should consider the issuance of an inadequate records notice at the conclusion of the examination. See IRM 4.10.3.19, Inadequate Records Notices: Overview.

4.10.4.4  
(06-01-2004)  
**In-Depth Examinations of Income**

- (1) If, as a result of completing the minimum income probes, the examiner identified inaccurate reporting of income from known sources, cannot reconcile the income reported on the tax return to the taxpayer's books and records, cannot reconcile a financial status analysis, identified unexplained bank deposits, determined that the taxpayer's internal controls are inadequate, or determined for any reason that there is reasonable indication of additional unreported income, then a more in-depth examination of income will be made.

4.10.4.4.1  
(05-27-2011)  
**Guidelines for In-Depth Examinations of Income**

- (1) The depth of the in-depth examination of income will be tailored to each taxpayer. Sensitivity to the taxpayer's reaction to additional in-depth probes must be balanced with the need for the proper and fair administration of tax laws.
- (2) The in-depth examination of income is distinguishable from the minimum income probes by the use of third-party contacts to obtain information or evidence to reconcile income issues.
- (3) Where indicated, examiners should first pursue specific items of income that can be documented with direct evidence. These adjustments are easiest to defend and may eliminate the need to use a formal indirect method to make the actual determination of tax liability. This approach is appropriate when the taxpayer maintains books and records, adjustments may be due to technical issues (such as timing or character of funds), or the potential sources of the unreported income are limited (such as an insurance agent who underwrites for several companies). The specific item approach is not useful if the taxpayer's gross receipts are generated from numerous sources or in small amounts, such as a grocery store.
- (4) The use of a formal indirect method to make the actual determination of tax liability should be pursued when the taxpayer's books and records are missing, incomplete, or irregularities are identified; or the financial status analysis indicates a material imbalance after consideration of specific adjustments identified during the examination. Choosing the formal indirect method most suitable for the examination is extremely important. See IRM 4.10.4.5.2, Using Formal Indirect Methods to Reconstruct Income, for an additional discussion.
- (5) Procuring evidence, and its evaluation, are an integral part of the process. Refer to the following IRM sections:
- a. IRM 4.10.7.3, Evaluating Evidence, which includes discussions of oral testimony, observations, and documentary evidence.
  - b. IRM 4.10.7.4, Arriving at Conclusions, which includes a discussion of taxpayer credibility and reasonable determinations.

4.10.4.4.2  
(08-09-2011)  
**In-Depth Examinations  
of Income: Individual  
Taxpayer**

- (1) Follow-up on evidence of potential sources of additional unreported income. This audit technique does not trigger the provisions of IRC 7602(e) regarding the use of financial status audit techniques; thus, there is no requirement that the IRS have a reasonable indication of a likelihood of unreported income.
- (2) Attempt to resolve an unbalanced financial status analysis by taking the following actions:
  - a. Reduce the unexplained understatement of taxable income by any excess of net bank deposits over reported gross receipts discovered during the bank/financial account analysis;
  - b. Include any audit adjustments made due to failure to substantiate claimed expenses; and

**Note:** The financial status analysis should be continually revised as new information about business and personal expenses becomes available.

  - c. Update estimated personal living expenses as information becomes available.

**Reminder:** It is inappropriate to affirmatively ask the taxpayer to identify actual personal living expenses or complete Form 4822, Statement of Annual Estimated Personal and Family Expenses. For purposes of the financial status analysis, estimated personal living expenses using Bureau of Labor statistics are sufficient. Refining personal living expenses for actual costs should be limited to completion of a formal indirect method to make the actual determination of tax liability. See IRM 4.10.4.5.1.2, Limitation on Use of Examination Techniques: Personal Living Expenses.
- (3) Discuss any potential understatement of taxable income with the taxpayer and/or representative. The taxpayer may have information that was not previously disclosed to the examiner that will resolve the imbalance.
  - a. Consideration should be given to credible oral testimony, such as reasonableness of gifts of cash from relatives. See IRM 4.10.7.3.2, Oral Testimony, for in-depth discussion of oral testimony and documentation requirements.
  - b. Loan proceeds should be documented with the loan application and records of disbursement. The documents should be reviewed to confirm the amount and terms of the loan, as well as determining if the information on the loan application is consistent with information on the return. Differences should be reconciled and may lead to additional sources of income.
- (4) When appropriate, third-party contacts should be made to corroborate oral testimony. Information should be collected, to the greatest extent practicable, directly from the taxpayer to whom it relates. However, external sources of information (third parties) can be used to update the financial status analysis, verify expenses, or corroborate the taxpayer's oral testimony and explanations.
  - a. Under IRC 7602(c), third party contacts may not be initiated before giving advance notice to the taxpayer that contacts other than with the taxpayer may be made.

- b. Request that the taxpayer complete Form 6014, Authorization — Access to Third Party Records for Internal Revenue Service Employees. This form gives a third party written authorization from the taxpayer to provide information directly to the examiner.
- c. Use standard Letter 1995, Third Party Contact Letter to Request Information, to secure information from third parties.
- d. Issue an administrative summons to the third party if the taxpayer is not cooperative. Pursuant to IRC 7602(a), Authority to summon, etc., the IRS has the authority to issue a summons to any person who has information for any bona fide civil tax audit, collection purpose or criminal investigation of any offense connected with the administration or enforcement of the internal revenue laws. To enforce an administrative summons, the IRS must demonstrate that (1) there is a legitimate purpose; (2) the inquiry is relevant to the purpose; (3) the information is not already in the possession of the IRS; and (4) the administrative steps required by the Code and regulations have been followed. See *United States v. Powell*, 379 U.S. 48, 57-58 (1964).
- e. A variety of external sources of information are available. For example, a credit application completed by the taxpayer to secure a bank loan may reflect income consistent with the audit adjustment. See *Job Aid - External Sources of Information*.
- f. Information from third parties may be secured via telephone with the taxpayer present. This is the easiest and most efficient method. Depending upon the information sought, oral testimony may be all that is needed to resolve the issue.
- g. In some circumstances interviewing the third party should be considered. A summary of the interview or statement made should be prepared and signed by the third party. If a more formal written statement is desired, a Form 2311, Affidavit, should be used. See IRM 4.10.7.3.2.
- h. Information from third parties will be verified, to the extent practicable, with the taxpayer or representative before action is taken. See IRM 4.11.57, Third-Party Contacts, for more information on taxpayer notification requirements.

4.10.4.4.3  
(08-09-2011)

**Audit Techniques for the  
In-Depth Examinations  
of Income: Corporations  
and Other “Business”  
Returns**

- (1) The minimum income probes described in IRM 4.10.4.2.4 are comprehensive. Therefore, after performing the minimum income probes, examiners should use their judgment when determining which financial status audit techniques are most suitable for additional in-depth income probes. Refer to IRM 4.10.3.7.5, Step 5: Determination of the Depth of the Examination of the Taxpayer’s Books and Records, and IRM 4.10.3.7.6, Step 6: Reconciling the Taxpayer’s Books and Records to the Tax Return.
- (2) Bank records serve as backup documents to the taxpayer’s records and can also provide leads to transactions not disclosed in the books and records. A complete discussion is included in IRM 4.10.3.9, Bank Record Reconciliations. The extent of the bank/financial account reconciliation will depend on the circumstances of the case and will be more important when records are inadequate, nonexistent, or possibly falsified.
- (3) An apparent understatement of taxable income for a corporation, or the identification of income diverted to a shareholder or partner, will normally require a concurrent in-depth examination of the related taxpayers. Refer to IRM 4.10.4.2.4.6 and IRM 4.10.5.4, Related and Spin-Off Returns, for suggested elements for an in-depth examination of income for an individual shareholder/

partner. Refer to IRM 4.10.4.5, Formal Indirect Methods of Determining Income, for general guidance for using formal indirect methods.

- (4) When appropriate, third party contacts should be made to corroborate oral testimony. See IRM 4.10.4.4.2 (4) for complete discussion.

4.10.4.4.4  
(05-27-2011)  
**Results of an In-Depth  
Examination of Income**

- (1) After completion of the in-depth examination of income, the examiner should decide the next step using the following decision criteria:

IF	THEN
The taxpayer or third parties have successfully explained the reason for the understatement.	Document the results in the workpapers and conclude the examination of income without adjustment.
The adjustments to income and understatement meet the criteria for referral to Criminal Investigation.	A referral should be made to Criminal Investigation.
The taxpayer agrees to the proposed adjustments to income. There is no indication of additional unreported income.	Document the results in the workpapers and make the adjustment, resolve other issues, and close the case agreed.
The taxpayer does not agree to the proposed adjustments to income and the adjustments are <b>not</b> based on <b>estimated</b> personal living expenses derived from BLS data or comparable statistics.	Document the results in the workpapers and close the case unagreed.
The taxpayer does not agree to the proposed adjustments to income and the adjustments are based on <b>estimated</b> personal living expenses derived from BLS data or comparable statistics.	Consider using one of the formal indirect methods to determine the actual amount of unreported income. <b>Note:</b> A case should not be closed unagreed if adjustments to income are based on <b>estimated</b> Personal Living Expenses.

4.10.4.5  
(05-27-2011)  
**Formal Indirect Methods  
of Determining Income**

- (1) The formal indirect methods used to determine tax liabilities involve the development of circumstantial proof of income through the use of bank deposits, source and application of funds, ratio analyses, or changes in net worth.
- (2) The purpose of this section is to provide guidance for examiners when using formal indirect methods of reconstructing income. The five basic formal indirect methods of reconstructing income discussed are:
- Source and Application of Funds Method (IRM 4.10.4.5.3)

- b. Bank Deposits and Cash Expenditures Method (IRM 4.10.4.5.4)
- c. Markup Method (IRM 4.10.4.5.5)
- d. Unit and Volume Method (IRM 4.10.4.5.6)
- e. Net Worth Method (IRM 4.10.4.5.7)

(3) IRM 4.10.4.5, Formal Indirect Methods of Determining Income, is organized into the subsections listed below. Key court decisions which allow for the use of formal indirect methods, when to use a specific method, formulas, and examples are included in the discussions of the different methods. Common defenses which an examiner may encounter in cases where a formal indirect method is used are also discussed in the sections below:

- a. IRM 4.10.4.5.1, Authority to Use Formal Indirect Methods (Financial Status Audit Techniques)
- b. IRM 4.10.4.5.2, Using Formal Indirect Methods to Reconstruct Income
- c. IRM 4.10.4.5.8, Potential Taxpayer Defenses Against Formal Indirect Methods of Computing Income
- d. IRM 4.10.4.5.3, Source and Application of Funds Method
- e. IRM 4.10.4.5.4, Bank Deposits and Cash Expenditures Method
- f. IRM 4.10.4.5.5, Markup Method
- g. IRM 4.10.4.5.6, Unit and Volume Method
- h. IRM 4.10.4.5.7, Net Worth Method

4.10.4.5.1  
(05-27-2011)

**Authority to Use Formal Indirect Methods (Financial Status Audit Techniques)**

- (1) Neither the Code nor the regulations define or specifically authorize the use of the formal indirect methods. However, IRC 446(b), Exceptions, provides that if no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.
- (2) If the examiner has a reasonable indication that unreported income exists, the IRS has been granted the authority, through the development of case law, to use a formal indirect method of reconstructing income to determine whether or not the taxpayer has accurately reported total taxable income received.
- (3) The “formal” indirect method need not be exact, but must be reasonable in light of the surrounding facts and circumstances. *Holland v. United States*, 348 U.S. 121, 134 (1954).

4.10.4.5.1.1  
(06-01-2004)

**Limitation on Use of Formal Indirect Methods (Financial Status Audit Techniques)**

- (1) Formal indirect methods and the techniques used to support their development are collectively known as “financial status audit techniques” and trigger IRC 7602(e), which states 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.”
- (2) “Financial Status Audit Technique” was defined as the use of formal indirect methods in the Government Accounting Offices’ report, “More Criteria Needed on IRS’ Use of Financial Status Audit Techniques,” GAO/GGD-98-38.



4.10.4.5.1.2  
(08-09-2011)  
**Limitation on Use of  
Examination  
Techniques: Personal  
Living Expenses**

- (1) "Examination techniques" include examining and testing the taxpayer's books and records, analytical tests, observing, and interviewing the taxpayer. None of these techniques are unique to the use of a formal indirect method and do not trigger the limitation of IRC 7602(e).
- (2) Examiners should adjust PLE based on information received during the interview and update the T-Account during the audit process. In developing the PLE for the T-Account, examiners should only use the PLE information that was made available through the minimum income probes.
- (3) Obtaining PLE information beyond the minimum income probes will likely trigger the limitation of IRC 7602(e). If there are indications of unreported income and you need to go beyond the minimum income probes, use a Financial Status Audit Technique and document your files with the reasons to support your use of the indirect method.
- (4) Form 4822, Statement of Annual Estimated Personal and Family Expenses, may be used as a guide by the examiner for determining the taxpayer's personal living expenses. The form lists the typical expenses incurred by most individuals. It is inappropriate to ask the taxpayer to complete the form independently.
- (5) Care should be taken to avoid duplicating amounts when modifying estimates for actual costs.

4.10.4.5.1.3  
(05-27-2011)  
**Use of Bureau of Labor  
Statistics Data or Other  
Statistical Information to  
Reconstruct Taxable  
Income**

- (1) In certain cases, as described below, income may be reconstructed using BLS data or comparable statistics from a reliable source. The analysis is completed using the tables for annual expenses, not income, because determining the expenses represents a better reflection of the actual costs to maintain a household.
- (2) The BLS data can be accessed at *Bureau of Labor Statistics*, select "Inflation and Consumer Spending." Tables specific to year, region within the United States, and individual expenses are available.
- (3) Statistical data cannot be used as a substitute for reconciling the taxpayer's books and records. If the taxpayer provides information, or information becomes available, which shows that income in a specific amount was earned, statistical data cannot be used to increase income to the national average.
- (4) In court proceedings involving individuals, IRC 7491(b), Use of statistical information on unrelated taxpayers, may shift the burden of proof. IRC 7491(b) provides that the IRS will have the burden of proof for any item of income where income is reconstructed using only BLS data or other comparable statistical information on unrelated taxpayers.

4.10.4.5.1.3.1  
(08-09-2011)  
**When to Use Statistical  
Data**

- (1) Statistical data can be used in conjunction with other available information (tax return information, IRP documents, etc.) at any time.
- (2) Statistical data should be used as the **sole** source of information needed to calculate taxable income only when **no other information is available**. The following are examples of conditions where statistical data may be used as the sole source:
  - a. The taxpayer is in a business or income producing activity other than as an employee and no information is available. Evidence of employment

and wages earned, such as a filed Form W-2, constitutes evidence precluding the use of statistical data unless the taxpayer can be placed in an unrelated income producing activity that could have generated unreported income. See *Senter v. Commissioner*, T.C.M. 1995-311.

- b. If the taxpayer is a nonfiler. If the taxpayer filed a tax return and reported income, then the examiner must use other recognized methods (specific item, indirect methods) to confirm or reconstruct additional income. Statistical data is not a substitute for obtaining and considering relevant evidence in reaching a determination. See IRM 4.10.4.2.5.
- c. The taxpayer must be uncooperative with the examiner during the audit. Examples of noncooperation include a taxpayer who is not willing to meet with the examiner or provide any information or records regarding income producing activities, whether or not the examiner has been able to actually identify that activity. Examiners must use judgment to determine whether the taxpayer is cooperative. Examiners must use all available administrative tools, including the summons enforcement, to gather necessary information before statistical data is used.

4.10.4.5.1.3.2  
(08-09-2011)

**Case Law for Using  
Statistical Data**

- (1) In *Miller v. Commissioner*, T.C.M. 1993-121, the taxpayer filed tax returns for 1982-1985, but they contained virtually no information other than his name, address, occupation, filing status, and the number of exemptions claimed. The various line items on the returns either stated "none" or were footed to statements containing specific objections based upon amendments to the United States constitution. The taxpayer signed the returns, but added a disclaimer. The taxpayer was totally uncooperative during the audit and did not provide books or records. Bank records were used to reconstruct the taxpayer's business receipts and expenses. Because the bank records reflected virtually no personal expenditures, BLS cost-of-living data was used to determine income attributable to some other untraced source from which personal expenses were paid in addition to the reconstructed gross business receipts. The Court sustained the use of BLS data under these circumstances, except where the BLS figures appeared to be duplications of expenses paid from the bank/financial accounts.
- (2) In *Portillo v. Commissioner*, 932 F.2d 1128 (5th Cir. 1991), the examiner relied upon a filed *Form 1099* to determine that a taxpayer had additional unreported income. The taxpayer agreed he had additional income, but not the amount reported on the *Form 1099*. Ultimately, the filer of the *Form 1099* was only able to document the portion of additional income with which the taxpayer agreed. The statutory notice of deficiency reflected the entire amount shown on the *Form 1099*. The Court found that the notice of deficiency was arbitrary because it merely matched the taxpayer's return with the *Form 1099*, assuming the taxpayer's return was false and the *Form 1099* was correct. In such circumstances, the IRS is obligated to investigate.
- (3) In *Senter v. Commissioner*, T.C.M. 1995-311, the taxpayer failed to provide requested information or appear for scheduled meetings. The taxpayer's correspondence with the examiner raised "protestor" type arguments. The taxpayer did not comply with, and objected to, administrative summonses, but the examiner did not seek enforcement. The notice of deficiency reflected unreported income determined using prior year reported earnings adjusted by the Consumer Price Index (CPI). The Court held this determination of unreported

income to be arbitrary and erroneous. Some predicate (preexisting) evidence establishing income was necessary to support a determination of unreported income.

#### 4.10.4.5.2

(05-27-2011)

##### **Using Formal Indirect Methods to Reconstruct Income**

- (1) Examiners are cautioned that the use of a formal indirect method will be determined on a case-by-case basis. The use of a formal indirect method to make the actual determination of tax liability is not a substitute for reconciling whatever books are maintained by the taxpayer to the tax return. The use of a “formal” indirect method, however, is not precluded by the presentation of books and records. See *Lipsitz v. Commissioner*, 21 T.C. 917 (1954).

#### 4.10.4.5.2.1

(05-27-2011)

##### **When to Use a Formal Indirect Method**

- (1) The use of a formal indirect method to make the actual determination of tax liability should be considered when the factual development of the case leads the examiner to the conclusion that the taxpayer’s tax return and supporting books and records do not accurately reflect the total taxable income received and the examiner has established a reasonable likelihood of unreported income.
- (2) The following list, which is not intended to be all inclusive, identifies circumstances that, individually or in combination, would support the use of a formal indirect method.
  - a. A financial status analysis that cannot be balanced (i.e., the taxpayer’s known business and personal expenses exceed the reported income per the return and nontaxable sources of funds have not been identified to explain the difference).
  - b. Irregularities in the taxpayer’s books and weak internal controls.
  - c. Gross profit percentages change significantly from one year to another, or are unusually high or low for that market segment or industry.
  - d. The taxpayer’s bank/financial accounts have unexplained items of deposit.
  - e. The taxpayer does not make regular deposits of income, but uses cash instead.
  - f. A review of the taxpayer’s prior and subsequent year returns show a significant increase in net worth not supported by reported income.
  - g. There are no books and records. Examiners should determine whether books and/or records ever existed, and whether books and records exist for the prior or subsequent years. If books and records have been destroyed, determine who destroyed them, why, and when.
  - h. No method of accounting has been regularly used by the taxpayer or the method used does not clearly reflect income. See IRC 446(b).

#### 4.10.4.5.2.2

(06-01-2004)

##### **Selecting a Formal Indirect Method**

- (1) The selection of a formal indirect method is critical to effectively and efficiently determine the tax liability. For example, although the Bank Deposits and Cash Expenditures Method and the Source and Application of Funds Method are frequently used, they are not the most effective methods if cash is not deposited and/or the cash outlays cannot be determined unless voluntarily disclosed by the taxpayer. Realistically, it may be difficult to identify significant personal acquisitions or expenditure that the taxpayer has deliberately camouflaged. These weaknesses can be overcome by using a formal indirect method based on the taxpayer’s business activities to make the actual determination of tax liability (i.e., the Markup Method or Unit and Volume Method).

(2) The following factors should be considered when selecting a formal indirect method:

- a. The industry or market segment in which the taxpayer operates,
- b. Inventories are a principal income producing activity,
- c. Suppliers can be identified and/or merchandise is purchased from a limited number of suppliers,
- d. Merchandise and/or service pricing is reasonably consistent,
- e. The volume of production and variety of products,
- f. Availability and completeness of the taxpayer's books and records,
- g. The taxpayer's banking practices,
- h. The taxpayer's use of cash to pay expenses,
- i. Expenditures exceed income,
- j. Stability of assets and liabilities, and
- k. Stability of net worth over multiple years under audit.

4.10.4.5.2.3  
(05-27-2011)

**Documenting the  
Decision to Use a  
Formal Indirect Method**

(1) The reasons why the examination of income was expanded to include the use of a formal indirect method to make the actual determination of tax liability should be documented in the workpapers, as well as why a specific method was selected. Notations on the lead sheet is not sufficient. The documentation should include a narrative explaining how the evidence in the file establishes the likelihood of unreported income, and justifying the use of a formal indirect method. The documentation should include:

- a. A summary of the facts relevant to the decision,
- b. Procedures and audit techniques used up to that point,
- c. Manager's comments (if appropriate),
- d. Any other information relevant to the decision, and
- e. Conclusions.

(2) Document likely sources of taxable income. It is not essential to pinpoint the specific source, but only to indicate the possibility of, or the opportunity for, likely sources of taxable income. To the extent that the possible source(s) can be identified, the more credible the results of a formal indirect method will be. Possible sources can be demonstrated by:

- a. Specific omissions,
- b. Demonstrating that the taxpayer's business had the capacity to generate more gross receipts, or
- c. Comparisons over time.

(3) The documentation should be prepared concurrent to the decision (i.e., before using a formal indirect method to make the actual determination of tax liability).

4.10.4.5.2.4  
(05-27-2011)

**Management Approval**

(1) Group manager approval is not required when initiating the use of a formal indirect method, except for the Net Worth Method (see IRM 4.10.4.5.7.2 (2)).

4.10.4.5.3  
(09-11-2007)

**Source and Application  
of Funds Method**

- (1) The Source and Application of Funds Method is an analysis of a taxpayer's cash flows and comparison of all known expenditures with all known receipts for the period. Net increases and decreases in assets and liabilities are considered along with nondeductible expenditures and nontaxable receipts. The excess of expenditures over the sum of reported and nontaxable income is the adjustment to income.
- (2) The Source and Application of Funds Method and the financial status analysis are both based on an evaluation of the taxpayer's cash flows. The only difference is the use of statistics to estimate unknown personal living expenses. Therefore, when the financial status analysis indicates a reasonable likelihood of unreported income and establishes a reasonable likelihood of unreported income, the Source and Application of Funds Method is an efficient method for determining the actual amount of the understatement of income.

4.10.4.5.3.1  
(09-11-2007)

**Case Law (Source and  
Application of Funds  
Method)**

- (1) Source and Application of Funds Method use as proof in establishing unreported income received the Supreme Court's approval in *United States v. Johnson*, 319 U.S. 503 (1943). In addition to proving the taxpayer owned gambling establishments whose winnings were unreported, it was proven that in three of the years involved, the taxpayer's personal expenditures exceeded his current income plus his declared accumulated funds.

4.10.4.5.3.2  
(09-11-2007)

**When to Use the Source  
and Application of  
Funds Method**

- (1) This method is based on the theory that any excess expense items (applications) over income items (sources) represent an understatement of taxable income.
- (2) The Source and Application of Funds Method is recommended in the following situations:
  - a. The review of a taxpayer's return indicates that the taxpayer's deductions and other expenditures appear out of proportion to the income reported.
  - b. The taxpayer's cash does not all flow from a bank/financial account which can be analyzed to determine its source and subsequent disposition.
  - c. The taxpayer makes it a common business practice to use cash receipts to pay business expenses.

4.10.4.5.3.3  
(08-09-2011)

**Example of Source and  
Application of Funds  
Method**

- (1) Sources of funds are the various ways the taxpayer acquires money during the year. Decreases in assets and increases in liabilities generate funds. Funds also come from taxable and nontaxable sources of income. Unreported sources of income even though known, are not listed in this computation since the purpose is to determine the amount of any unreported income. Specific items of income are denoted separately. Examples of sources of funds include:
  - a. Decrease in cash-on-hand, in bank/financial account balances (including personal and business checking and savings accounts), and decreases in accounts receivable,
  - b. Increases in accounts payable,
  - c. Increases in loan principals and credit card balances,
  - d. Taxable and nontaxable income, and
  - e. Deductions which do not require funds such as depreciation, carryovers and carrybacks, and adjusted basis of assets sold.

- (2) Application of funds are ways the taxpayer used (or expended) money during the year. Examples of applications of funds include:
  - a. Increases in cash-on-hand, increase in bank/financial account balances (including personal and business checking and savings accounts), business equipment purchased, real estate purchased, and personal assets acquired,
  - b. Purchases, business expenses,
  - c. Decreases in loan principals and credit card balances, and
  - d. Personal living expenses.
- (3) Determining the beginning amount of cash-on-hand and accumulated fund for the year is important. See IRM 4.10.4.5.8.3 below for possible defenses the taxpayer might raise regarding the availability of nontaxable funds.
- (4) See *Example - Source and Application of Funds Method - Computation for Cash and Accrual Based Taxpayer*.

4.10.4.5.3.4  
(05-27-2011)  
**Accrual Basis Taxpayer**

- (1) Since the results of this method are on a cash basis, adjustments must be made for an accrual basis taxpayer. Accounts receivable at the beginning of the period examined are shown on the debit side, as they are presumed to be collected during the period. Ending accounts receivables are a credit adjustment, required to effect a non-cash increase in income.
- (2) Accounts payable are shown as adjustments in the reverse order of accounts receivables. Beginning accounts payable are a credit adjustment having the result of increasing income and transferring a current period cash expenditure to the prior period in which it was incurred and deductible under the accrual method. Conversely, ending accounts payable balances are a debit adjustment having the effect of reducing income to result in a non-cash reduction of income.
- (3) See *Example - Source and Application of Funds Method - Computation for Cash and Accrual Based Taxpayer*.

4.10.4.5.4  
(05-27-2011)  
**Bank Deposits and Cash Expenditures Method**

- (1) An important feature of any examination is the inspection or analysis of the taxpayer's bank records. This is particularly so in the examination of inadequate, nonexistent or possibly falsified books and records. The depth of the bank/financial account analysis (see IRM 4.10.4.2.3.7) will depend upon the facts and circumstances of the individual case. When the bank/financial account **analysis** indicates a reasonable likelihood of unreported income, the examination of income may be expanded to include the use of the formal **Bank Deposits** and Cash Expenditures Method to determine the actual understatement of taxable income.
- (2) In summary, income is proven through a detailed, in-depth analysis of all bank deposits, cancelled checks, currency transactions, and electronic debits, transfers, and credits to the bank/financial accounts AND identification of the taxpayer's cash expenditures. The Bank Deposits and Cash Expenditures Method is distinguished from the Bank Account Analysis by:
  - a. The depth and analysis of **all** the individual bank account transactions, and
  - b. The accounting for cash expenditures, and
  - c. Determination of actual personal living expenses.



- (3) The Bank Deposits and Cash Expenditures Method computes income by showing what happened to a taxpayer's funds. It is based on the theory that if a taxpayer receives money, only two things can happen: it can either be deposited or it can be spent.
- (4) This method is based on the assumptions that:
  - a. Proof of deposits into bank/financial accounts, after certain adjustments have been made for nontaxable receipts, constitutes evidence of taxable receipts.
  - b. Outlays, as disclosed on the return, were actually made. These outlays could only have been paid for by credit card, check, or cash. If outlays were paid by cash, then the source of that cash must be from a taxable source unless otherwise accounted for. It is the burden of the taxpayer to demonstrate a nontaxable source for this cash.
- (5) The Bank Deposits and Cash Expenditures Method can be used in the examination of both business and nonbusiness returns.
- (6) The Bank Deposits and Cash Expenditures Method may supply leads to additional unreported income, not only from the amounts and frequency of deposits, but also by identifying the sources of such deposits. Determining how deposited funds are dispersed or accumulated (to whom and for what purpose) might also provide leads to other sources of income.
- (7) If the Bank Deposits and Cash Expenditures Method indicates an understatement of taxable income, it may be due to either underreporting of gross receipts or overstating expenses, or a combination of both.

4.10.4.5.4.1  
(09-11-2007)  
**Case Law (Bank  
Deposits and Cash  
Expenditures Method)**

- (1) The classic bank deposits case is *Gleckman v. United States*, 80 F.2d 394 (8th Cir. 1935). The court held that standing alone bank deposits and large items of receipts do not prove additional tax due. On the other hand, if it is shown that these amounts can be associated with a business or income-producing activity, then the income is taxable. Since the Gleckman case, the Bank Deposits Method has received consistent judicial approval.
- (2) The Gleckman case, and the cases that followed, taught that in order to use the Bank Deposits and Cash Expenditures Method in determining income, it must be shown that:
  - a. The taxpayer was engaged in a business or income-producing activity,
  - b. The taxpayer made periodic deposits of funds into a bank/financial account or accounts,
  - c. An adequate investigation of deposits was made by the examiner to negate or eliminate the likelihood the deposits arose from nontaxable sources of income, and
  - d. Unidentified bank deposits have the inherent appearance of income (i.e., the size of the deposits, odd or even amounts, source of checks deposited, dates of deposits, etc.).

4.10.4.5.4.2  
(09-11-2007)  
**When to Use the Bank  
Deposits and Cash  
Expenditures Method**

- (1) The Bank Deposits and Cash Expenditures Method should not be the automatic choice when selecting a formal indirect method. For example, cash intensive businesses, where significant amounts of gross receipts are not deposited and numerous cash outlays occur, do not lend themselves to this method.

- (2) If the Bank Deposits and Cash Expenditures Method is the method of choice, the entire analysis must be completed; shortened versions that do not account for business and personal cash expenditures are insufficient.
- (3) The Bank Deposits and Cash Expenditures Method is recommended when:
  - a. The taxpayer's books and records are unreliable, unavailable, withheld, or incomplete.
  - b. The taxpayer makes periodic deposits of funds into bank/financial account(s) which appear to be generated from an income-producing activity.
  - c. The taxpayer pays most business expenses by check, credit cards, debit cards, etc.
  - d. The taxpayer previously used bank/financial account deposits to determine and report taxable income.
- (4) The advantages of the Bank Deposits and Cash Expenditures Method include:
  - a. Provides a complete picture of the taxpayer's activities; it clearly reflects the size and scope of the taxpayer's financial activities.
  - b. Avoids necessity of documenting business expenses, except for technical adjustments such as depreciation.
  - c. When the taxpayer overstates business expenses, the overstatement is automatically accounted for in the mechanics of the computation. It is not necessary to audit expenses claimed on the tax return.

4.10.4.5.4.3  
(09-11-2007)

**Bank Deposit Defined**

- (1) Total deposits include amounts deposited from both taxable and nontaxable sources to all bank/financial accounts (both business and personal) maintained or controlled by the taxpayer, as well as deposits made to accounts in savings and loan companies, investment trusts, brokerage houses, credit unions, and other financial institutions.

4.10.4.5.4.4  
(09-11-2007)

**Gross Receipts Defined**

- (1) Gross receipts represents the total or gross taxable receipts of the taxpayer during the year from all sources, not reduced by returned sales and allowances, cost of goods sold, basis, or expenses. gross receipts, or gross business receipts, can be determined by computing the sum of the three items listed below and deducting nontaxable and/or nonbusiness receipts, duplicated deposits, etc.
  - a. Funds received by a taxpayer during the year, which were deposited in financial institutions, such as banks, savings and loan associations, investment accounts, etc.
  - b. Funds expended that were not deposited.
  - c. Funds accumulated and not deposited.
- (2) Gross receipts includes, but is not limited to the following:
  - a. Gross sales of a trade or business
  - b. Gross fees and commissions
  - c. Gross wages, salaries, tips, and gratuities
  - d. Gross dividends, interest, rents, royalties, pensions, and annuities
  - e. Gross income from estates, trusts, and partnerships
  - f. Gross proceeds from the sale of assets
  - g. Gross farm income

- (3) Gross receipts does not include nontaxable income, such as, but not limited to, gifts, inheritances, loan proceeds, transfers between accounts, checks to cash redeposited, tax exempt interest, insurance proceeds, and federal tax refunds.

4.10.4.5.4.5  
(09-11-2007)

**Factors to Consider**

- (1) Are there any unusual or extraneous deposits which appear unlikely to have resulted from reported sources of income?
- a. **Size of Deposit** — Due to the need for expediency, the examiner may limit the examination to large deposits or deposits over a certain amount. However, the identification of smaller regular deposits may be indicative of dividend income, interest, rent, or other income, leading to a source of investment income.
  - b. **Kind of Deposit** — An item of deposit may be unusual due to the kind of deposit, check or cash, in its relationship to the taxpayer's business or source of income. An explanation may be required if a large cash deposit is made by a taxpayer whose deposits normally consist of checks. Also, a bank statement noting only one or two large even dollar deposits, in lieu of the normal odd dollar and cents deposits, would be unusual and require an explanation.
  - c. **Pattern and Frequency of Deposits** — Many taxpayers, due to the nature of their business or the convenience of the depository used, will follow a set pattern in making deposits. Deviation from this pattern may bear questioning.
  - d. **Frequency of Deposits** — Bank statements or deposit slips which indicate repeat deposits of the same amount on a monthly basis, quarterly or semi-annual basis may indicate rental, dividend, interest or other income accruing to the taxpayer.
  - e. **Location of Bank on Which the Check Was Drawn** — The examination of deposit slips may indicate items of deposit which appear questionable due to the location of the bank on which the deposited check was drawn. It is common practice when preparing a deposit slip to list either the name of the bank, city of the bank or identification number of the bank upon which the deposited check was drawn. If an identification number is used, the name and location of the bank can be determined by reference to the banker's guide. In all cases, if the location of the bank on which the check for deposit was drawn bears little relation to the taxpayer's business location or source of income, it may indicate the need for further investigation.
- (2) Are there any loan proceeds, collection of loans, or extraneous items reflected in deposits? In the analysis of bank deposits, the examiner should identify all items of this nature. This is a necessary step before comparing receipts to deposits.
- a. If loan proceeds are identified, request the loan application documents to verify the source and amount of the nontaxable funds. Review the loan application information for consistency with other information such as: cash flows, assets, anticipated gross receipts, etc. Discrepancies should be resolved with the taxpayer's assistance.
  - b. If repayments of loans are identified, request the debt instruments to establish a loan was made, the terms of the debt, and the repayment schedule. Ask the taxpayer to document the flow of funds to the borrower (e.g., a cancelled check) and to explain where the money came from (e.g., Accumulated Funds). Ask how much money has been collected to

date and whether the taxpayer reported interest earned. Contact the party receiving the loan and ask for a notarized statement outlining the terms of the loan, when it was received, and the amount of money repaid.

- (3) Are there transfers between bank/financial accounts or redeposits?
  - a. Before an examiner can reach any conclusion about the relationship between deposits and reported receipts, transfers and redeposits must be eliminated.
  - b. For example, if a taxpayer draws a check to cash for the purpose of cashing payroll checks and then redeposits these payroll checks, the examiner would be incorrect if total deposits were compared to receipts reported without adjusting for this amount. The taxpayer has done nothing more than redeposit the same funds in the form of someone else's checks.
- (4) Are there personal or nonbusiness bank/financial accounts?
  - a. Unreported income may be found in personal accounts. If the analysis is limited to an inspection of the business bank/financial accounts only, omitted taxable income in personal accounts may not be discovered.
  - b. The examiner should ascertain whether the deposits, as reflected in these accounts, can be accounted for by withdrawals or transfers from business accounts or from other known sources of funds.
  - c. The examiner should not overlook the possibility of more than one personal or business/financial bank account.
- (5) Are the deposits in personal and business accounts, as adjusted, during short periods of time, accounted for by the records?
  - a. It is not unusual to find that total deposits will reconcile on a yearly basis with the total receipts for the year reported on the tax return.
  - b. A closer examination of deposits on a weekly or monthly basis may indicate that these deposits do not reconcile with the receipts reported during the same periods.
  - c. Reported receipts may not be deposited in the closing months of the year to balance out the excess of deposits and the understatement of receipts in the earlier months.

4.10.4.5.4.6  
(08-29-2025)  
**Gross Receipts Formula**

- (1) The Bank Deposits and Cash Expenditures Method is used to determine gross receipts **from all sources** (i.e., it is not limited to consideration of business receipts and it is not necessary to audit or verify expenses deducted on the return). See *Job Aid - Gross Receipts Formula* for a basic formula for computing the understatement of taxable income and *Example - Bank Deposits and Cash Expenditures Method - Computation of Gross Receipts* for examples.

4.10.4.5.4.6.1  
(08-09-2011)  
**Explanation of Formula for Bank Deposits and Cash Expenditures Method**

- (1) The following is an explanation of the specific items used in above computation. The items are identified by the line number. See *Example - Bank Deposits and Cash Expenditures Method - Computation of Gross Receipts*.
- (2) **Line 1:** Total bank deposits means total deposits in all of the taxpayer's bank/financial accounts. This includes the taxpayer's business and personal accounts, the spouse's accounts, and dependent children's accounts (this could vary if the spouse files a separate return). The deposits should be recon-

ciled, if possible, so that only the receipts during the current year are included. This is accomplished by totaling deposits as shown on the bank/financial statements, adding to this amount any current year's receipts (which were deposited in the subsequent year), and deducting any prior year's receipts, which were deposited in the current year. See *Example - Bank Deposits and Cash Expenditures Method - Computation of Gross Receipts*.

- a. Analyze the deposits to identify those that appear unlikely to have resulted from the taxpayer's known business activity. Determining the source of the funds may result in the identification of additional sources of income.
  - b. Look for amounts that are unusually large (or small) or in even amounts, received on a regular basis, or currency when deposits normally consist of checks. These irregular deposits may indicate that not all gross receipts are deposited.
- (3) **Line 2:** Eliminate nontaxable deposits representing duplicated and nontaxable items. See *Example - Bank Deposits and Cash Expenditures Method - Computation of Gross Receipts*.
- a. Duplicated items include checks to cash where the proceeds are redeposited. An example is when the taxpayer writes a check payable to cash and obtains currency and/or coins from the bank in exchange for the check. This currency is then used to cash customers' checks, which are deposited into the taxpayer's bank/financial account; in effect, redepositing the funds withdrawn. This deposit must be eliminated in determining deposits from taxable receipts.
  - b. Transfers between accounts are another example of nontaxable receipts. Transfers can occur between different checking accounts, different savings accounts, and between savings accounts and checking accounts. Such transfers do not represent additional receipts since they are merely a shifting of funds from one account to another. Deposits from transfers must be eliminated in determining deposits from taxable receipts.
  - c. Loan proceeds should be documented with loan applications and records of disbursement. The documents should be reviewed to confirm the amount and terms of the loan and determine if the information supplied by the taxpayer on the loan application is consistent with information on the return. Differences should be reconciled and may result in the identification of additional sources of income.
  - d. Other common types of nontaxable receipts that are often deposited and must be eliminated in determining deposits from taxable receipts include gifts, inheritances, nontaxable Social Security benefits, nontaxable Veterans Administration benefits, tax refunds, etc.
- (4) **Line 3:** This line represents the total amount of net receipts **deposited** in bank/financial accounts. At this point, the examiner has completed a detailed reconciliation of the bank deposits.
- (5) The next step in the Bank Deposits and Cash Expenditures Method is determining the amount of gross receipts **never deposited** in the bank/financial accounts. The Bank Deposits and Cash Expenditures Method is incomplete and ineffective unless the cash expenditures are taken into account.
- (6) **Line 4:** Business expenses paid by cash are computed by determining the business expenses paid by check and subtracting this amount from the total business expenses reported on the tax return. Examiners should be satisfied

that all checks have been presented. Should the taxpayer remove any portion of the nondeductible checks, the analysis would result in an understatement of unreported income. See *Example - Bank Deposits and Cash Expenditures Method - Computation of Gross Receipts*.

- a. First determine total disbursements by adding the total deposits to the opening account balance, and then subtracting the ending balance. The resulting figure must then be adjusted for checks written during the year, which have not cleared the bank/financial account and checks written in the prior year, which cleared during the current year. This is merely a reconciliation of the checks so that only the current year's checks are taken into account.
- b. Then identify all the checks for personal expenses and purchases of assets (business and personal) that would not be deductible as a business expense on the tax return, and subtract from the total disbursements. The result will be the business expenses paid by check.

**Note:** Generally, the number of nonbusiness checks written is less than the number of business checks. Nonbusiness checks include checks for personal living expenses, capital purchases (personal and business), checks to cash redeposited, check transfers between accounts, and payments on liabilities. Checks for these items would be included even if the taxpayer deducted them on the return.

- c. Analyze the business expenses claimed on the tax return to eliminate expenses which are not cash outlays (i.e., depreciation, depletion, bad debts, etc.)
- d. Subtract the business expenses paid by check from the expenses requiring cash outlays claimed on the tax return. The result is the amount of business expenses paid by cash rather than check.

**Note:** This step is based on the assumption that outlays as disclosed on the return were actually made and could only have been paid for by either check or cash. The result could represent unsubstantiated business expenses. Effectively, the taxpayer is either underreporting gross receipts or overstating expenses. Either way, the adjustment amount is the same.

- (7) **Line 5:** Capital items paid by cash include cash purchases of capital assets, cash deposited in savings accounts, and cash used to make payments on liabilities or debt. For each item, determine how much the taxpayer paid during the year and subtract any payments made by check to arrive at the amount paid with cash.
  - a. Review information in the file included with the case building data.
  - b. Personal assets may be identified by reviewing state registrations and licenses, property records and building permits.
  - c. Review the depreciation schedules to identify business assets for which the taxpayer is making payments (i.e., the taxpayer does not have clear title.)
- (8) **Line 6:** Personal expenses paid by cash include living expenses, income taxes, etc. Personal items paid for by cash can be determined in the same manner as the business expenses paid by cash. Add up all the actual personal living expense identified as part of the financial status analysis and by complet-



ing Form 4822 with the taxpayer's assistance, and then subtract the personal living expenses paid by check. The remainder will be the personal living expenses paid with cash. Personal living expenses purchased with credit cards must also be considered.

- (9) **Line 7:** Cash accumulated during the year is the cash (undeposited currency and coins) received by the taxpayer during the year which is on hand at the end of the year (it was neither expended nor deposited). There are two considerations:
- Increases in cash-on-hand at the end of the year that is associated with normal business practices and the need to complete cash transactions with customers.
  - Increases in accumulations of funds that are not generally associated with normal business practices. Taxpayers may accumulate significant amounts of funds for personal use.
- (10) Examiners should establish the amount and verify the taxpayer's statements of cash-on-hand and cash accumulations early in the examination, before the likelihood of unreported income is established. This information is needed to complete the financial status analysis. Asking taxpayer's about cash-on-hand and cash accumulations does not violate IRC 7602(e), which requires the IRS to establish a likelihood of unreported income before using a financial status audit technique (formal indirect method) to make the actual determination of tax liability. For additional information see:
- IRM 4.10.4.1.6.5 and IRM 4.10.4.1.6.6
  - IRM 4.10.4.2.3.2 (3) and IRM 4.10.4.2.3.2 (6)
  - IRM 4.10.4.2.4.4 (4)
  - Interview Questions - Addressing Accumulated Funds*
- (11) **Line 8:** Nontaxable cash used for (4) through (7) is nontaxable cash used to pay expenses, purchase capital assets, deposit into savings accounts, make payments on liabilities, and to accumulate. It is important to get complete information about nontaxable income as efforts may be wasted if the taxpayer later provides information regarding the availability of nontaxable sources of funds to explain an understatement. See IRM 4.10.4.5.8.3 for possible defenses the taxpayer might raise regarding nontaxable sources of funds. Nontaxable cash includes:
- Loans not deposited,
  - Withdrawals from savings accounts not redeposited or transferred,
  - Gifts,
  - Inheritances,
  - Collection of loans receivable,
  - Nontaxable income, etc.
- (12) **Line 9:** To account for changes in accounts receivable for accrual basis taxpayers, subtract the beginning balance from the ending balance to determine the change. A net increase represents additional taxable gross receipts, a net decrease represents payments already included in prior year gross receipts. See IRM 4.10.4.5.4.6.2., Adjustments for an Accrual Basis Taxpayer, for complete discussion of adjustments for accrual basis taxpayers.
- (13) **Line 10:** To account for changes in accounts payable for accrual basis taxpayer, subtract the beginning balance from the ending balance to determine

the change. A net increase results from purchases on account during the year and is subtracted from gross receipts. A net decrease results from payments on account during the year in excess of purchases on account and is added to gross receipts. See IRM 4.10.4.5.4.6.2, Adjustments for an Accrual Basis Taxpayer, for complete discussion of adjustments for accrual basis taxpayers.

- (14) **Line 11:** Gross receipts as corrected should be compared to the gross receipts reported on the tax return to compute the adjustment to income.

4.10.4.5.4.6.2  
(05-27-2011)

**Adjustments for an  
Accrual Basis Taxpayer**

- (1) If the taxpayer is on the accrual basis, the differences between the beginning and ending balances of accounts receivable and accounts payable should be added to or subtracted from the corrected gross receipts to convert the computation to the accrual basis accounting method. In some cases, it will not be practical to determine the amount of accounts receivable and accounts payable due to the inadequacy of the records. In such cases, these adjustments may be ignored unless the amount appears to be material. Changes in the balances of accounts receivable and accounts payable should be handled as listed in the paragraphs below.
- (2) An increase in accounts receivable is added to gross receipts. An increase in receivables results from sales on accounts during the year being exceeding collections on account during the year. Therefore, the taxpayer has income from sales that is not reflected in deposits or cash expended because the cash has not yet been received. This increase is added to gross receipts, as determined, so that the taxpayer's current income is properly reflected.
- (3) A decrease in accounts receivable is subtracted from gross receipts. A decrease in receivables results from collections on account during the year. Therefore, the taxpayer has received cash during the year which is attributable to sales made in a previous year. This decrease is subtracted from gross receipts so that the taxpayer's current income is properly reflected.
- (4) An increase in accounts payable is subtracted from gross receipts. An increase in accounts payable results from purchases on account during the year. This affects the bank deposit computation in the following manner:
  - a. The total outlays per return includes all purchases and expenses deducted on the return regardless of whether or not they were all paid (except depreciation, amortization, etc.). Thus, the amount of accounts payable at the end of the year is included in total outlays per return.
  - b. The taxpayer presumably paid for all purchases and expenses incurred during the year, except for the accounts payable balance at the end of the year, and also paid off the accounts payable amount owing at the beginning of the year. Business expenses paid by check include all such payments (i.e., payments on accounts payable and payments of current expenses).
  - c. The amount of business expenses paid by cash, which is added to deposits and other cash expenditures in arriving at gross receipts, is determined by subtracting business checks from total outlays per return.
  - d. If the balance of accounts payable at the end of the year is greater than the balance at the beginning of the year, the total outlays per return will be greater than the actual amount paid by check and cash. Therefore, if an increase in accounts payable is NOT subtracted from gross receipts, the amount of business expenses paid by cash will be overstated in the

amount of the increase in accounts payable, and the gross receipts as determined will be overstated in the same amount.

- (5) A decrease in accounts payable is added to gross receipts. A decrease in accounts payable results from payments on account during the year being in excess of purchases on account during the year. This has the direct opposite effect on the bank deposit computation as an increase in accounts payable discussed in paragraph 4 above. In other words, the total outlays per return will be less than the actual amount paid by check and cash. This will result in an understatement of business expenses paid by cash in the amount of the decrease in accounts payable, and an understatement of the gross receipts as determined in the same amount.

4.10.4.5.4.6.3  
(09-11-2007)

#### **Bank Service Charges**

- (1) Bank service charges are charged to a depositor's account for various reasons. They appear on bank statements in the same manner as checks except that they are identified by code letters which are keyed to explanations. If all of these charges are allowable business expenses, no adjustment is necessary in the computation. The charges will automatically be reflected in the total checks written (beginning bank balance plus deposits less ending bank balance) and business expenses paid by check (total checks written less nonbusiness checks). Any charges which are not allowable business expenses should be included with the nonbusiness checks.

4.10.4.5.4.6.4  
(05-27-2011)

#### **Returned Checks**

- (1) Checks deposited by the taxpayer but returned by the bank are charged to the taxpayer's account. This situation arises when the taxpayer deposits a check which is not paid by the bank on which it is drawn for some reason. For example, the maker of the check did not have sufficient funds in the account to pay the check, the maker did not have an account, etc. Since these items are reflected in the closing bank balances, no adjustments in the bank deposit computations are required.

4.10.4.5.4.6.5  
(08-29-2025)

#### **Overdrawn Accounts**

- (1) A bank/financial account is overdrawn when the amount of the depositor's outstanding checks is greater than the balance on deposit in the account. Normally, this situation will have no effect on the bank deposit computation. It will merely entail the use of negative bank balances in the computation of total checks written.
- (2) After the corrected gross receipts is determined, a comparison must be made with the amount reported on the return to arrive at the adjustment to income.
- (3) The understatement of gross receipts and/or overstatement of expenses is added to the taxable income reported on the return.
- (4) See *Job Aid - Income Computation - Overdrawn Account* for an example computation.

4.10.4.5.4.7  
(08-09-2011)

#### **Adjustments to Non-Cash Expenses**

- (1) The Bank Deposits and Cash Expenditures Method does not account for non-cash expenses claimed on the tax return that do not represent a current outlay of funds. Examples include depreciation, depletion, bad debts, and inventory. Therefore, these expenses should be separately considered and specific item adjustments made if necessary. For example, if the bank deposit computation revealed an adjustment of \$5,000 and depreciation claimed was found to be overstated in the amount of \$1,000, there would be two adjustments:

- a. Unreported income in the amount of \$5,000, and
- b. Adjustment to depreciation in the amount of \$1,000

4.10.4.5.5  
(08-09-2011)  
**Markup Method**

- (1) The Markup Method produces a reconstruction of income based on the use of percentages or ratios considered typical for the business under examination to make the actual determination of tax liability. It consists of an analysis of sales and/or cost of sales and the application of an appropriate percentage of markup to arrive at the taxpayer's gross receipts. By reference to similar businesses, percentage computations determine sales, cost of sales, gross profit, or even net profit. By using some known base and the typical applicable percentage, individual items of income or expenses may be determined. These percentages can be obtained from analysis of Bureau of Labor Statistics data or industry publications. If known, use of the taxpayer's actual markup is required.
- (2) The Markup Method is a formal indirect method that can overcome the weaknesses of the Bank Deposits and Cash Expenditures Method, Source and Application of Funds Method, and Net Worth Method, which do not effectively reconstruct income when cash is not deposited and the total cash outlays cannot be determined unless volunteered by the taxpayer. If personal enrichment occurs that cannot be identified, the effectiveness of these methods is diminished. For example, the possibility exists that significant personal acquisitions or expenditures are paid with cash and are not evident. The Markup Method is similar to how state sales tax agencies conduct audits. The cost of goods sold is verified and the resulting gross receipts are determined based on actual markup.
- (3) This method is most effective when applied to businesses whose inventory is regulated or purchases can be readily broken down in groups with the same percentage of markup.
- (4) An effective initial interview with the taxpayer is the key to determining the pertinent facts specific to the business being examined.

4.10.4.5.5.1  
(08-09-2011)  
**Case Law (Markup Method)**

- (1) In *United States v. Fior D'Italia, Inc.*, 536 U.S. 238 (2002), the majority held that IRC 446(b) does not limit authority to use aggregate estimation of income taxes (unreported tip income).
- (2) In *Barragan v. Commissioner*, T.C.M. 1993-92, the IRS properly determined gross receipts from a gas station based on the supplier's delivery records and the retail prices per an independent market survey. Similarly, in *Stafford v. Commissioner*, T.C.M. 1992-637, the IRS properly determined gross receipts from gas stations based on Bureau of Labor Statistics data.
- (3) In *Nichols v. Commissioner*, T.C.M. 1983-242, the IRS was upheld in applying an established tip rate to the taxpayer's gross receipts to determine unreported tip income.
- (4) In *Webb v. Commissioner*, 394 F.2d 366, 371-372 (5th Cir. 1966), aff'g T.C.M. 1966-81, the government determined Webb's income from liquor sales using the Markup Method.
- (5) It was held in the *Estate of Bernstein v. Commissioner*, T.C.M. 1956-260, that the inability to use other "formal" indirect methods is not prerequisite for using a percentage method.

- (6) In the case of *Yorkville Live Poultry Co. v. Commissioner*, 18 BTA 47 (1929), the Board of Tax Appeals approved a net income computation based upon four percent of the net sales where no books were available.

## 4.10.4.5.5.2

(05-27-2011)

**When to Use the Markup Method**

- (1) The Markup Method is recommended in the following situations:
- When inventories are a principal income producing factor and the taxpayer has nonexistent or unreliable records.
  - Where a taxpayer's cost of goods sold or merchandise purchased is from a limited number of sources, these sources can be ascertained with reasonable certainty, and there is a reasonable degree of consistency as to sales prices.
- (2) This method is effective for industries such as liquor stores, taverns, gasoline retailers, restaurants, and jewelry stores.
- (3) Examiners should address the following issues when applying the Markup Method:
- Use the taxpayer's own records and oral testimony to establish the markup percentages based on known costs and sales prices. This should be the best source of information. Plausible explanations for why the taxpayer's markup percentages differ from national averages should be accepted.
  - If it appears that the cost of goods sold and/or purchases are also understated, issue a summons to the taxpayer's suppliers for sales records.
  - Judgment should be exercised by examiners when using industry standards or surveys to make sure the comparisons are valid and are for similar situations. Consider the availability of valid sources of information containing the necessary percentages and ratios. Adjust percentages and ratios to reflect those during the time of the return under audit. IRC 7491(b) places the burden of proof on the IRS with respect to any item of income that was reconstructed **solely** through the use of statistical information on unrelated taxpayers.

## 4.10.4.5.5.3

(08-29-2025)

**Gross Profit Margin to Sales**

- (1) The gross profit to sales ratio indicates the average markup on products. The calculation divides the gross profit margin (sales less cost of goods sold) by total sales.
- (2) See *Example - Gross Profit Margin to Sales*.

## 4.10.4.5.5.4

(08-29-2025)

**Cost of Sales to Gross Receipts Ratio**

- (1) Using the cost of sales to gross receipts ratio is a variation of the gross profit margin to sales ratio. It also is a comparison of costs to sales.
- (2) See *Example - Markup Method - Cost of Sales to Gross Receipts Ratio* for an example.

## 4.10.4.5.6

(08-09-2011)

**Unit and Volume Method**

- (1) In many instances gross receipts may be determined or verified by applying the sales price to the volume of business done by the taxpayer. The number of units or volume of business done by the taxpayer might be determined from the taxpayer's books as the records under examination may be adequate as to cost of goods sold or expenses. In other cases, the determination of units or volume handled may come from third-party sources.

- (2) This method for determining the actual tax liability has been effectively applied in carry out pizza businesses, coin operated laundromats, and mortuaries.
- (3) See *Example - Unit and Volume Method Computation* for an example.

4.10.4.5.6.1  
(08-09-2011)  
**Case Law (Unit and Volume Method)**

- (1) In *Salami v. Commissioner*, T.C.M. 1997-347, the court held that a cab driver's gross income could be determined using claimed gas expenses, price per gallon, miles per gallon, occupancy rates, etc. Same for the cab driver in *Irby v. Commissioner*, T.C.M. 1981-399.
- (2) In *Maltese v. Commissioner*, T.C.M. 1988-322, the IRS was upheld in determining gross income by determining the number of pizza crusts per 100 pounds of flour times the average price per pizza.
- (3) In *Stanoch v. Commissioner*, T.C.M. 1959-132, the IRS established gross receipts for a tavern by allowing a specific measurement of liquor per drink and a percentage for spillage.

4.10.4.5.6.2  
(06-01-2004)  
**When to Use the Unit and Volume Method**

- (1) The Unit and Volume Method is recommended for making the actual determination of tax liability when:
  - a. The examiner can determine the number of units handled by the taxpayer and also know the price charged per unit.
  - b. The business has only a few types of products which are sold or there is little variation in the types of services performed, and the charges made by the taxpayer (sales price) for merchandise or services are relatively the same throughout the tax period.

4.10.4.5.6.3  
(06-01-2004)  
**Other Considerations**

- (1) Examiners should be aware of the following when considering the Unit and Volume Method:
  - a. Is there a common denominator for the business that drives gross receipts?
  - b. Can the number of units handled or consumed by the taxpayer be ascertained?
  - c. Is the price per unit or profit per unit obtainable?
  - d. Is there a third party from whom the taxpayer's consumption, units of production, or sales are available?

4.10.4.5.7  
(06-01-2004)  
**Net Worth Method**

- (1) The Net Worth Method for determining the actual tax liability is based upon the theory that increases in a taxpayer's net worth during a taxable year, adjusted for nondeductible expenditures and nontaxable income, must result from taxable income. This method requires a complete reconstruction of the taxpayer's financial history, since the government must account for all assets, liabilities, nondeductible expenditures, and nontaxable sources of funds during the relevant period.
- (2) The theory of the Net Worth Method is based upon the fact that for any given year, a taxpayer's income is applied or expended on items which are either deductible or nondeductible, including increases to the taxpayer's net worth through the purchase of assets and/or reduction of liabilities.
- (3) 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. The taxable portion of the income can be reconstructed by calculating the increase in net worth during the year, adding back the nondeductible items, and subtracting that portion of the income which is partially or wholly nontaxable.

- (4) The purpose of the Net Worth Method is to determine, through a change in net worth, whether the taxpayer is purchasing assets, reducing liabilities, or making expenditures with funds not reported as taxable income.

4.10.4.5.7.1  
(06-01-2004)  
**Case Law (Net Worth Method)**

- (1) The Net Worth Method is a very old method of determining income. See *United States v. Frost*, 25 F.Cas. 1221 (N.D. Ill. 1869). The first criminal case involving the Net Worth Method was *United States v. Beard*, 222 F.2d 84 (4th Cir. 1955), which involved delinquent returns.
- (2) The use of the Net Worth Method of proof has been approved by the Supreme Court in: *Holland v. United States*, 348 U.S. 121 (1954). Holland set forth the following requirements that the government must meet when using the Net Worth Method:
- Establish an opening net worth, also known as the base year, with reasonable certainty.
  - Negate reasonable explanations by the taxpayer inconsistent with guilt (i.e., reasons for the increased net worth other than the receipt of taxable funds). Failure to address the taxpayer's explanations might result in serious injustice.
  - Establish that the net worth increases are attributable to currently taxable income.
  - Where there are no books and records, willfulness may be inferred from that fact coupled with proof of an understatement of taxable income. But where the books and records appear correct on their face, an inference of willfulness from net worth increases alone might not be justified.
  - The government must prove every element beyond a reasonable doubt, though not to a mathematical certainty.

4.10.4.5.7.2  
(08-09-2011)  
**When to Use the Net Worth Method**

- (1) The Net Worth Method is generally recommended in the following situations:
- Two or more years are under examination.
  - Numerous changes to assets and liabilities are made during the period.
  - No books and records are maintained.
  - The books and records are inadequate or not available.
  - The books and records are withheld by the taxpayer.
- (2) The Net Worth Method should be used only if:
- The group manager concurs that the Net Worth Method is the more appropriate method and should be used, or
  - Criminal Investigation has requested that the Net Worth Method be used.
- (3) The fact that the taxpayer's books and records accurately reflect the figures on a return does not prevent the use of the Net Worth Method of proof. The government can still look beyond the "self-serving declarations" in a taxpayer's books and records and use any evidence available to determine whether the books accurately reflect the taxpayer's financial history.

- (4) While the Net Worth Method was originally used against taxpayers whose principal source of income was from an illegal activity, it is now regularly recommended in fraud cases, especially where significant changes in net worth have occurred and other methods of proof are insufficient.
- (5) In addition to being used as a primary means of proving taxable income so that an actual determination of tax liability can be made, the Net Worth Method is relied upon to corroborate other methods of proof and test the accuracy of reported taxable income.

4.10.4.5.7.3  
(08-29-2025)  
**Formula for the Net Worth Method**

- (1) A complete discussion of the computation for the Net Worth Method and associated audit techniques is included in IRM 9.5.9.5, Net Worth Method of Proof.
- (2) See *Job Aid - Net Worth Formula*.

4.10.4.5.8  
(05-27-2011)  
**Potential Taxpayer Defenses Against Formal Indirect Methods of Computing Income**

- (1) If the use of a formal indirect method results in the identification of an understatement of taxable income, the examiner must ensure that the formal indirect method was applied correctly to eliminate any potential defense the taxpayer may use to discredit the results.
- (2) The defenses can be grouped into three categories:
  - a. Showing that the computation is inaccurate or flawed,
  - b. Showing that the unexplained difference is due to a nontaxable source, or
  - c. Showing that the unexplained difference is from expenditures of available cash accumulated in prior years.

4.10.4.5.8.1  
(08-09-2011)  
**Computation is Inaccurate or Flawed**

- (1) Bank Deposits and Cash Expenditures Method — Most challenges to the accuracy of this method focus on the nature of the individual deposits in the account(s). The taxpayer may claim that the deposits consist of taxable and nontaxable items that were not correctly classified by the examiner. Deposits of loan proceeds, gifts and inheritances, as well as transfers from other accounts are some of the most common claims. Redeposits of items, such as insufficient funds checks, may also cause inaccuracy if counted twice. The examiner should carefully review the analysis and attempt to identify the source and character of each deposit before presenting results as an understatement of taxable income.
- (2) Source and Application of Funds Method — Challenges are made to the adjustments for the accrual method of accounting and the handling of loan transactions (i.e., loan payments are an application of funds). Also, the taxpayer may claim that purchases, labor costs, materials and supplies, and other current period costs associated with inventory are an application of funds rather than the cost of goods sold.
- (3) Markup Method — The main challenges to this method are to show that the computation relies upon improper percentages, improper cost of sales, or that the examiner's computation fails to give adequate consideration to significant items such as spillage, breakage, or theft losses. These issues should be addressed and quantified during the initial interview. Since the method relies on a comparison of a situation similar to that under examination, defenses

could be formulated based on dissimilarities in several areas such as type of merchandise handled, size of the operation, locality, time period covered, or general merchandising policy.

## 4.10.4.5.8.2

(06-01-2004)

**Unexplained Difference is Due to a Nontaxable Source**

- (1) The taxpayer may attempt to refute the findings of the examiner's formal indirect method by claiming the unexplained difference is actually caused by the receipt of nontaxable sources of funds.
- (2) If it can be shown that all nontaxable sources of income have been considered, then it can be concluded that the only likely source remaining is a taxable one. Examiners need to show that increases in taxable income arose from a likely taxable source. This can be demonstrated by specific omissions, showing the taxpayer's business had the capacity to generate more sales, or comparisons over time. To the extent that the possible source can be identified, the more acceptable the computation will be.

## 4.10.4.5.8.3

(08-09-2011)

**Unexplained Difference is Due to Cash-on-Hand or Accumulated Funds**

- (1) The taxpayer may attempt to refute the findings of the examiner's formal indirect method by claiming the unexplained difference is actually caused by the use of nontaxable funds accumulated in prior years.
- (2) Since cash-on-hand and accumulated funds are important fundamental aspects of the examination of income and the formal indirect methods, examiners should establish the amount and verify the taxpayer's statements of cash accumulations during the initial interview. This is necessary because:
  - a. Cash-on-hand and accumulated funds can explain potentially significant imbalance in the Financial Status Analysis. The issue can be resolved quickly and with the least amount of burden to the taxpayer if it is addressed early in the examination.
  - b. The information is needed to determine whether a formal indirect method should be used, and which method is most appropriate.
  - c. An adjustment for unreported income can be challenged if the availability of cash-on-hand and accumulated funds is not addressed at the beginning of the audit. The after-the-fact "cash in the mattress" defense cannot be used if the actual cash-on-hand and accumulated funds have already been established.
- (3) In order to avoid any misunderstanding by the taxpayer, it is important that the meaning of cash-on-hand and accumulated funds be explained prior to answering any inquiry. Taxpayers must understand the term cash-on-hand means any undeposited currency and coins used for normal business transactions. Accumulated funds refers to cash accumulated by the taxpayer and is not associated with normal business practices and/or transactions with customers. The funds may have been taxed in prior years, originate from nontaxable sources, or may represent taxable income in the year under audit. Once the terms are understood, the examiner should inquire as to the existence of any cash-on-hand and accumulated funds. *See Interview Questions - Addressing Accumulated Funds.*
- (4) If a taxpayer attempts to avoid answering questions concerning cash, examiners should try to pinpoint amounts by starting with an estimate such as "over or under \$10,000" and narrowing the range until the taxpayer agrees with a general amount.

- (5) A commitment should be sought concerning whether an individual had any large accumulations of cash during the tax period under audit. Examiners should ask the taxpayer to make an affirmative statement regarding the existence or nonexistence of cash-on-hand and accumulated funds.
- (6) If taxpayers allege that they have what appears to be an inordinate amount of cash, the examiner should further inquire to establish:
  - a. The amount of cash-on-hand at the end of each year under examination to the present (at the time of the interview).
  - b. How it was accumulated.
  - c. Where it was kept and in what denominations.
  - d. Who had knowledge of it.
  - e. Who counted it.
  - f. When and where any of it was spent.
  - g. Why did the taxpayer accumulate the cash-on-hand.
- (7) Information regarding cash-on-hand and accumulated funds is necessary to establish the consistency and reliability of the taxpayer's statement. Usually no direct corroborating evidence is available, but statements made about the source and use of the funds can be verified. Look for inconsistencies. For example:
  - a. The taxpayer may not have had sufficient taxable or nontaxable income in prior years to accumulate cash.
  - b. Taxpayer claims of substantial cash-on-hand or accumulated funds might be discredited by showing that the taxpayer borrowed money, made installment purchases, incurred large debts, was delinquent on accounts, had a poor credit rating, or filed for bankruptcy. Demonstrating that the taxpayer lived sparingly may suggest that the taxpayer does not have accumulated funds, but showing that the taxpayer lived sparingly does not necessarily discredit a taxpayer's assertion that they had substantial accumulated funds. Cultural differences and individual philosophies regarding money management may explain the taxpayer's chosen lifestyle.
  - c. Financial statements filed by the taxpayer at banks and other places could be reviewed to see if the taxpayer disclosed the cash-on-hand on these statements.
- (8) A taxpayer's explanation for cash-on-hand or accumulated funds 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 (i.e., contemporaneously to the event).

4.10.4.6  
(12-23-2016)  
**Access to Suspicious  
Activity Reports (SARs)  
for Title 26 Civil Tax  
Purposes**

- (1) The **Financial Crimes Enforcement Network (FinCEN)** is a bureau of the U.S. Department of the Treasury that provides a modernized foundation to better collect, store, safeguard, analyze and share data obtained pursuant to Treasury's regulatory authority under the Bank Secrecy Act (BSA). FinCEN's mission is to safeguard the financial system from illicit use, combat money laundering and promote national security through the collection, analysis, and dissemination of financial intelligence and strategic use of financial authorities.
- (2) The Currency and Foreign Transactions Reporting Act, commonly referred to as "The Bank Secrecy Act (BSA)", requires U.S. financial institutions to assist

federal agencies to detect and prevent money laundering. This assistance is provided by the filing of information reports, including Suspicious Activity Reports (SAR). See IRM 4.26.4.3, BSA Reports Found on FinCEN Query.

- (3) FinCEN authorized access to SARs for Title 26 civil income tax purposes in a memorandum of understanding dated September 24, 2010, see IRM 4.26.14-2, Memorandum of Understanding Dated September 24, 2010. SARs can also be accessed for case-building activities when the case subject is assigned to a case-building group, function, or project.

4.10.4.6.1  
(12-23-2016)  
**Utility of SAR  
Information**

- (1) SAR information may be helpful in case building and examination activities when:
  - a. Potential indicators of fraud are present,
  - b. FinCEN Query (FCQ) reflects a CTR, foreign bank and financial account report (FBAR) or SAR,
  - c. Routine means of locating banking information are exhausted,
  - d. Unusually large number of cash transactions or cash transactions of unusually large amounts are evident (e.g., it appears the taxpayer is operating on a cash basis to avoid proper reporting of income),
  - e. There has been a failure to voluntarily disclose offshore accounts or entities,
  - f. Voluntary disclosure exists or offshore bank/financial accounts are suspected, or
  - g. Whistleblower claims involving unreported income, offshore bank/financial accounts or activities have been filed.

4.10.4.6.2  
(12-23-2016)  
**Accessing SAR  
Information**

- (1) Due to the sensitivity and need for careful oversight of access to and use of SAR information, access to FCQ search engine is limited to SAR Super Users (gatekeepers). T
- (2) Managers of Super users must conduct and document audit trail reviews of SAR access by comparing queries against retained copies of approved Form 10509-A, FinCEN Query SAR Request, and AMDIS summaries to ensure queries were related to assigned cases. Guidance for completion of the reviews can be found in IRM 4.26.14.3.3 (10), Access to SARs for Tax Purposes. Reviews must be conducted in January of each year and may be conducted in conjunction with annual workload reviews. The SB/SE FinCen Query Coordinator's contact information is listed on the *FinCEN Super User Lookup Tool*, of the SB/SE Field Examination FinCEN Requests Knowledge Management site.
- (3) Examiners not authorized access to FinCEN Query can request a search for SARs by a gatekeeper or super user. Prior to requesting SARs, the examiner and the group manager are required to complete security briefings. SAR gatekeepers and super users, as well as their managers, must also complete security briefings. Refer to IRM 4.10.4.6.5, for information on security briefings.

4.10.4.6.3  
(12-23-2016)  
**Guidelines for SAR Data  
Security and Disclosure  
Considerations**

- (1) **The unauthorized disclosure of SAR information violates federal law 31 U.S.C. 5318(g)(2)(A)(ii).** Such disclosures undermine the very purpose for which the suspicious activity reporting system was created. Unauthorized disclosure of SARs can threaten the safety and security of those institutions and individuals who file such reports.

- (2) Once Title 31 SAR information is used in a Title 26 civil tax examination or collection action, **the SAR information becomes confidential return information and is subject to both Title 31 restrictions on disclosure and IRC 6103, Confidentiality and disclosure of returns and return information, disclosure restrictions.**
- (3) **SARs and SAR information must be treated with the same security as information received from a confidential informant.** See IRC 6103(h)(4), Disclosure to certain federal officers and employees for purposes of tax administration, etc., for restrictions placed upon the IRS regarding disclosure of return information that identifies a confidential informant.
- (4) Although SAR information can be used for civil tax purposes, **no SAR information, including the existence of a SAR, can be disclosed in the course of any compliance activity to the filer of the SAR, the subject of the SAR, or to any party outside the IRS.**
- (5) An examiner can issue a summons to a bank/financial institution for records of account that were disclosed in a SAR. However, if there is a need to secure information underlying the filing of a SAR the examiner **cannot** contact the bank/financial institution, or issue a summons for SAR background information without prior consultation with the SB/SE FinCEN Query Coordinator listed on the *FinCEN Super User Lookup Tool*, of the SB/SE Field Examination FinCEN Requests Knowledge Management site. The FinCEN Query Coordinator will coordinate with the BSA FinCEN Liaison.

**Reminder:** Within IRS, SAR information can only be shared on a need to know basis.

- (6) Access to SAR information is subject to Unauthorized Access (UNAX) guidelines and must only be made in connection with specific and assigned tax administration matters. Managers of examiners requesting SAR information must ensure a request is related to assigned inventory before it is approved. See IRM 4.10.4.6.4 for guidance on how to get the SAR information. See IRM 10.5.5, IRS Unauthorized Access, Attempted Access or Inspection of Taxpayer Records (UNAX) Program Policy, Guidance and Requirements, for UNAX guidelines.
- (7) A suspected unauthorized disclosure or loss of SAR information **must** be reported within one hour of a user becoming aware of it. See IRM 4.26.14.6.4, SAR Unauthorized Disclosure Procedures, for procedures that must be followed.

#### 4.10.4.6.3.1 (12-23-2016)

#### Required Case Actions to Protect SARs and SAR Data

- (1) The following procedures must be followed to protect SARs and SAR data:
  - a. **Attach Form TD F 15-05.11 (2007), Sensitive But Unclassified (SBU) Cover Sheet, to the outside of any case file containing a SAR or SAR information.** This cover sheet is used to prevent unauthorized or inadvertent disclosure when SBU information is removed from an authorized storage location and persons without a need-to-know are present or casual observation would reveal SBU information.
  - b. **Keep all SARs and SAR information inside a sealed confidential envelope labeled "SAR Information".** This includes both SARs filed on the case subject and SARs filed by the case subject. Attach Form TD F 15-05.11 (2007) to the outside of the envelope.



- c. Every effort should be made to exclude from the workpapers any reference to the fact that the case involves a SAR. If workpapers include information regarding the SAR or information derived from the SAR, the workpapers **must** be maintained in the confidential envelope.
- d. Upon advice of Counsel and the Disclosure Office, compliance employees must respond to public inquiries on how information contained in a SAR became known by replying: **I cannot disclose that information. The authority to withhold that information is contained in Internal Revenue Code section 6103(e)(7).**
- e. When closing the case, the confidential envelope must be placed inside the case file on top of all other documents.

4.10.4.6.4  
(12-23-2016)  
**Procedures to Secure  
SAR Information**

- (1) The following procedures must be followed to secure SAR information:
  - a. The examiner must complete an electronic version of Form 10509-A and forward it to the group manager, along with a current AMDIS displaying a summary of what is on AIMS. Gatekeepers and super users must also follow this procedure before researching SARs for cases in their inventory. **Browsing is an offense reportable to the Treasury Inspector General for Tax Administration (TIGTA).**
  - b. The manager must review the completed Form 10509-A and compare it to the AMDIS to ensure the case is in active inventory before approving it.
  - c. Once approved the form should be digitally signed and sent electronically to the Area SAR gatekeeper or super user, along with the AMDIS.
  - d. The SAR gatekeeper or super user will perform the necessary electronic research.
  - e. If SARs are available, the SARs will be downloaded and sent to the examiner through secure, encrypted email. If no SARs are filed on the individual in question, the requesting examiner will be notified electronically that no SARs are available.
  - f. The examiner must keep a copy of the approved request, AMDIS, related emails and SAR material in a sealed confidential envelope with *Other Gov TDF 15-05.11* attached to the outside of the envelope.
  - g. The examiner and group manager must protect SARs and SAR data as outlined in IRM 4.10.4.6.3.
  - h. Form 10509-A and related AMDIS must be printed and maintained in a secure location in the SAR gatekeeper's or super users group for a period of one year or until a SAR audit trail review covering those requests is completed.

4.10.4.6.5  
(12-23-2016)  
**SAR Training  
Requirements**

- (1) Examiners and managers must complete certain Integrated Talent Management (ITM) training courses prior to requesting, accessing or reviewing SAR data.
- (2) Examiners must take the following IRM training courses:
  - 36427, Safeguarding, Requesting and Using Suspicious Activity Report (SAR) Security Briefing
  - 41166, Safeguarding Online Access and Using Suspicious Activity Report (SAR) Info Briefing
- (3) Managers must take the following ITM training courses:
  - 36428, Manager SAR Audit Trail Reviews

- 41167, Manager Online Suspicious Activity Report (SAR) Audit Trail Reviews Briefing

4.10.4.7  
(08-29-2025)  
**Currency Transaction  
Reports (CTR)  
Information**

- (1) Financial institutions, including casinos, must report each receipt and each withdrawal of currency exceeding \$10,000 by filing a Financial Crimes Enforcement Network (FinCEN) CTR. See IRM 4.26.5.5.1, Currency Transaction Reports, for information on the FinCEN forms used for reporting CTRs. CTR information can assist the examiner with:

- Making decisions on the need to complete additional auditing techniques,
- Questioning sources of income not subject to withholding tax, and
- Generating leads for potential unreported income, money laundering transactions and other tax avoidance schemes.

- (2) As part of the in-depth pre-contact analysis, Information Returns Processing Transcript Requests (IRPTR) should be reviewed for CTR data. See IRM 4.10.2.3, In-Depth Pre-Contact Analysis. IRM 2.3.35-57, Payee Online Transcript Document Display Screen: Form FinCEN CTR 112 (DOC CODE 89), provides an explanation of the CTR data contained on the IRPTR.

**Caution:** The CTR data on the IRPTR contains minimal information, and the total reflected could be an aggregate of several unrelated transactions. Examiners must complete Form 10509, FinCEN Query (FCQ) Request, to request a full copy of the CTR. See IRM 4.26.4.5.4, Gatekeeper or Super User Procedures, for instructions on making this request. Contact information for Super Users can be found at: *FinCEN Super User Lookup Tool*.

**Reminder:** In addition to CTR data, IRPTR reflects other information return documents, which are used to complete the IRP income reconciliation.

- (3) Examiners must also be alert to the possibility that CTRs exist but are not reflected on the IRPTR. If CTR information is NOT present on the IRPTR, examiners should consider requesting FCQ data by following the procedures in IRM 4.26.4.5.4 in the following situations:

- Potential indicators of fraud are present,
- Routine means of locating banking information are exhausted,
- An unusually large number of cash transactions or cash transactions of unusually large amounts are evident (e.g., it appears the taxpayer is operating on a cash basis to avoid proper reporting of income),
- A pattern of CTR filings stops, but business activities remain consistent,
- Offshore bank/financial accounts or entities exist or are suspected, and
- Whistleblower claims alleging unreported income or offshore banking activities have been filed.

**Note:** IRM 4.26.14-2, Memorandum of Understanding dated September 24, 2010, sets forth the terms under which FinCEN will provide the IRS with access to information collected pursuant to the reporting authority contained in the BSA, 31 U.S.C. section 5311, for purposes of administering and enforcing the provisions of Title 26 of the United States Code.

- (4) The existence of a CTR means the person or entity named was a party to a cash transaction (deposit or withdrawal) totaling more than \$10,000. Examiners must use their investigative skills to determine whether the currency involved

belongs to the person making the transaction, or if the transaction was completed on behalf of another party (either related or unrelated). Caution must be exercised when reviewing CTR information from FCQ Reports as there may be instances where information reflected is for an unrelated party. Examiners must determine whether the transaction(s) belong to the taxpayer and result in taxable income for the year under examination. The transaction may be from reported income, income taxed in another period, a non-taxable source, or unreported income. Examiners should take the following actions to trace information from the full copy of the CTR:

- a. Determine if the identifying information on the CTR is for the taxpayer under examination.
- b. Determine if the bank/financial account shown on the CTR ties to the taxpayer being examined. If the CTR transaction cannot be traced to any of the taxpayer's accounts, the examiner should determine if the transaction was made on behalf of an entity related to the taxpayer. This information may be helpful in determining the examination potential of the related entity.
- c. If the transaction reflected on the CTR was made from a financial account for the taxpayer being examined, trace the transaction to the taxpayer's bank account.
- d. Use the financial account information to determine the origin of the transaction.
- e. The true owner of the funds may not be identified on the CTR. If the examiner is unable to determine any relationship between the CTR and the taxpayer through analysis of the financial accounts, the examiner should ask the taxpayer if they were a party to any cash transactions over \$10,000. The examiner must develop the facts around the transactions and determine any impact on the tax liability.
- f. If the examiner is unable to trace the transaction that includes their taxpayer's name, and the taxpayer states they were not party to any cash transactions over \$10,000, the examiner should discuss issuing a summons for the bank/financial account noted on the CTR with their group manager to determine ownership of the account.

**Caution:** The actual CTR cannot be disclosed to the taxpayer or power of attorney. Data extracted from the CTR and reflected on the IRPTR can only be disclosed if the release will not impair tax administration. See IRM 11.3.41-18, FOIA and Title 26 Cases with CTRs or Data Extracted from CTRs, for information regarding disclosure of CTRs or CTR data reflected on IRPTR.

- (5) Examiners must document both the steps taken to trace a CTR and the conclusions reached regarding the impact on taxable income in the workpapers relating to the examination of income.

**Example:** The IRPTR reflects a CTR for \$15,000 "CASH-IN". A Form 10509 is submitted to secure a copy of the CTR. The CTR shows \$15,000 was deposited to the taxpayer's bank/financial account. The examiner must review the taxpayer's bank/financial account to locate the actual deposit. Once the deposit to the taxpayer's account is verified, the examiner can use the bank deposit information to discuss the item with the taxpayer.

**Example:** The bookkeeper for a car dealership makes a large deposit on behalf of the dealership to the car dealership's bank/financial account. The bookkeeper has no ownership interest in the dealership. Both the

bookkeeper, as an individual, and the car dealership are named on the CTR. In this scenario, the CTR may be reflected on the bookkeeper's individual IRPTR, even though the funds do not belong to the bookkeeper. Therefore, the examiner will not find the funds deposited into the bookkeeper's individual bank/financial account. **Note:** The bookkeeper is named in the CTR as making the transaction on behalf of the dealership, but the funds will be in the dealership's account. The name of the dealership and the account number will also be shown on the CTR.