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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL (SB/SE),
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FROM: Deborah A. Butler
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SUBJECT: Financial Status Audits

This Chief Counsel Advice responds to your request for advice. Chief Counsel Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

ISSUES:

1. Whether a revenue agent may drive by a taxpayer's house prior to having a reasonable indication that there is a likelihood of unreported income.

2. Whether a revenue agent may conduct a Lexis search to ascertain if the taxpayer purchased real estate during the year(s) at issue prior to having a reasonable indication that there is a likelihood of unreported income.

CONCLUSION:

1. A revenue agent may drive by a taxpayer's house prior to having a reasonable indication that there is a likelihood of unreported income.

2. A revenue agent may conduct a Lexis search to ascertain if the taxpayer purchased real estate during the year(s) at issue prior to having a reasonable indication that there is a likelihood of unreported income.

FACTS:

Revenue agents have inquired whether they are still permitted to drive by a taxpayer's house or conduct a Lexis search to ascertain if the taxpayer purchased real estate during the year(s) at issue prior to having a reasonable indication that there is a likelihood of unreported income in light of the enactment of section 7602(e), which restricts the use of financial status audit techniques.

LAW AND ANALYSIS

The Internal Revenue Service Restructuring and Reform Act of 1998 (RRA' 98), Pub. L. No. 105-206, section 3412, 112 Stat. 685 (July 22, 1998), added new I.R.C. § 7602(e), titled "Limitation on Financial Status Audit Techniques." Section 7602(e) provides that "[t]he Secretary shall not use financial status or economic reality examination techniques to determine the existence of unreported income of any taxpayer unless the Secretary has a reasonable indication that there is a likelihood of such unreported income."

The legislative history concerning RRA'98 section 3412 reflects that prior to its enactment, the Internal Revenue Service (Service) could use financial status or economic reality audit techniques to determine the existence of unreported income.

The legislative history states that RRA'98 section 3412 merely prohibits the use of such audit techniques to determine the existence of unreported income until the Service has a reasonable indication that there is a likelihood of such unreported income. H.R. Conf. Rep. No. 105-599, at 270 (1998).

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

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

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

When using an indirect method, a taxpayer's finances are reconstructed through circumstantial evidence. United States v. Hart, 70 F.3d 854, 860 n.8 (6th Cir. 1995). For example, the government shows either through increases in net worth, increases in bank deposits, or the presence of cash expenditures, that the taxpayer's wealth grew during a tax year beyond what could be attributed to the taxpayer's reported income, thereby raising the inference of unreported income. United States v. Black, 843 F.2d 1456, 1458 (D.C. Cir. 1988). Indirect methods are used to support an inference of unreported income from unidentified sources.

The bank deposits indirect method is an analysis of bank deposits to prove unreported income from unidentified sources. This method, which computes income by showing what happened to the taxpayer's funds, may be considered to be a financial status technique when it is used without specific knowledge of a possible traceable source. As such, it is used to supply leads to possible unreported income from sources of such deposits. Examination of Returns Handbook, IRM 4.2.4.6.3.

With the cash transaction indirect method, the Service calculates the unreported income as the amount that the taxpayer's cash expenditures exceeded the taxpayer’s sources of cash, including cash on hand at the beginning of the tax period in question, for the particular year. United States v. Hogan, 886 F.2d 1497, 1509 (7th Cir. 1989). The Service uses the taxpayer’s tax return and other sources to ensure that adequate income has been reported to cover expenses. GAO Report at 9.

The net worth method requires establishing the taxpayer's net worth at the start of the taxable year by listing all assets, including cash on hand, and all liabilities, with the balance being the taxpayer's net worth. A similar analysis is made for the first day of the next taxable year. To any change in the net worth, the Service adds non-deductible expenditures for living expenses, then deducts receipts from sources that are not taxable income and the amounts represented by applicable tax deductions and exemptions. If the increase in net worth, as adjusted, exceeds the reported taxable income, the inference is drawn that there is unreported income. United States v. Conway, 11 F.3d 40, 43 (5th Cir. 1993); United States v. Boulet, 577 F.2d 1165,1167 n.3 (5th Cir. 1978).

With the percentage of mark-up method, the Service reconstructs income derived from the use of percentages or ratios considered typical for the business or item under examination. This method consists of an analysis of either sales or cost of sales and the appropriate application of a percentage of markup to arrive at the taxpayer's gross profit. By reference to similar businesses or situations, percentage computations are secured to determine sales, cost of sales, gross profit or even net profit. Likewise, by the use of some known base and the typical percentage applicable, individual items of income or expenses may be determined. These percentages can be obtained from analysis of Bureau of Labor Statistics data, commercial publications, or the taxpayer's records for other periods. IRM 4.2.4.6.6.

With the unit and volume method, gross receipts are determined or verified by applying price and profit figures to the volume of business done by the taxpayer. The number of units or volume of business may be determined from the taxpayer's books and records if they adequately reflect cost of goods sold or expenses. This method is recommended when the Service can determine the number of units handled by the taxpayer and knows the price or profit charged per unit. IRM 4.2.4.6.7 and IRM 4.2.4.6.7.1.

We have not been provided with any specific factual circumstances under which a revenue agent would drive by a taxpayer’s house. Nonetheless, this activity would not be prohibited if used in determining whether there is a reasonable indication that there is a likelihood of unreported income so that the Service could resort to setting up unreported income under an indirect method. It should be noted that driving by a taxpayer’s house would not be an intrusion on that taxpayer. It should also be noted that the Internal Revenue Manual cautions that due to privacy issues and the intrusiveness of inspecting a taxpayer's residence, such inspections should be limited. The purpose of inspecting the taxpayer's residence includes, but is not limited to, determining the validity of deductions for an office or business located in the residence and determining the taxpayer's financial status. IRM 4.2.3.3.5.

Conducting a Lexis search to ascertain if the taxpayer purchased real estate would be useful when using the net worth method. Such a search would not be prohibited if used in determining whether there is a reasonable indication that there is a likelihood of unreported income so that the Service could resort to setting up unreported income under the net worth method or any other indirect method. It should be noted that a search of property records that are available to the public is not an intrusion on a taxpayer.

If you have any further questions, please call Administrative Provisions and Judicial Practice, Branch 3, at (202) 622-7940.

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By: ____________________________
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