



MANUAL TRANSMITTAL

Department of the Treasury
Internal Revenue Service

9.5.9

JULY 29, 2024

EFFECTIVE DATE

(07-29-2024)

PURPOSE

- (1) This transmits revised IRM 9.5.9, Methods of Proof.

MATERIAL CHANGES

- (1) Added required Internal Controls to comply with IRM 1.11.2.2.4, Address Management and Internal Controls and IRM 1.4.2, Resource Guide for Managers Monitoring and Improving Internal Controls.
- (2) Removed § throughout the IRM.
- (3) Editorial changes made throughout the IRM for clarity.

EFFECT ON OTHER DOCUMENTS

This IRM supersedes IRM 9.5.9, dated September 03, 2020.

AUDIENCE

Criminal Investigation

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9.5.9

Methods of Proof

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9.5.9.1
(07-29-2024)
Program Scope and Objectives

- (1) Purpose: This section will explain the various methods of proof available to the special agent in determining a subject's correct taxable income, and how to properly document each method of proof. The following methods of proof will be discussed in this section:
 - Specific Items,
 - Net Worth,
 - Expenditures,
 - Bank Deposits,
 - Cash Method,
 - Percentage Markup,
 - Unit and Volume.
- (2) Audience: All Criminal Investigation (CI) employees.
- (3) Policy Owner: Director, Assurance & Advisory (A&A) and Director, National Criminal Investigation Training Academy (NCITA).
- (4) Program Owner: Director, Assurance & Advisory (A&A) and Director, National Criminal Investigation Training Academy (NCITA).
- (5) Primary Stakeholders: All CI employees.
- (6) Contact Information: To make changes to this IRM section email CIHQIRM@ci.irs.gov.

9.5.9.1.1
(07-29-2024)
Background

- (1) This IRM was established to communicate new or revised instructions to employees regarding methods of proof.

9.5.9.1.2
(07-29-2024)
Authority

- (1) See IRM 9.1.2, Authority for the delegated authority relating to IRM 9.5.9, Methods of Proof.

9.5.9.1.3
(07-29-2024)
Roles and Responsibilities

- (1) The Director, A&A and Director, NCITA are responsible for overseeing this IRM and ensuring compliance with current policies and procedures.

9.5.9.1.4
(07-29-2024)
Program Management and Review

- (1) Program owners, Director, A&A, and Director, NCITA will:
 - a. Review the IRM annually.
 - b. Update the IRM when content is no longer accurate and reliable.
 - c. Incorporate all permanent interim content into the next revision of the IRM section prior to the expiration date.

9.5.9.1.5
(07-29-2024)
Program Controls

- (1) The Director, A&A, Director, NCITA, and program owners will review instructions and guidelines related to special agent reports and other IRS documents for procedural, operational, and editorial changes.

9.5.9.1.6
(07-29-2024)
Acronyms

- (1) The table lists commonly used acronyms and their definitions:

Acronym	Definition
A&A	Assurance & Advisory
ATM	Automated Teller Machines
CI	Criminal Investigation
DOJ	Department of Justice
FICA	Federal Insurance Contributions Act
FIFO	First-in, First-out
IRA	Individual Retirement
IRC	Internal Revenue Code
LIFO	Last-in, First-out
NCITA	National Criminal Investigation Training Academy
OID	Original Issue Discount Certificates
SEPP	Simplified Employee Pension Plan

9.5.9.1.7
(07-29-2024)

Related Resources

- (1) IRM 9.1.3, Criminal Statutory Provisions and Common Law.
- (2) IRM 9.6.4, Trial.

9.5.9.2
(11-05-2004)

Introduction

- (1) “Proof” is the establishment by evidence of a requisite degree of belief concerning a fact in the mind of the trier of fact or the court. Proof is the logically sufficient reason for assenting to the truth of a proposition advanced. In its judicial sense, it is a term of wide import and encompasses everything that may be adduced at a trial, within the legal rules, for the purpose of producing a conviction in the mind of judge or jury.
- (2) “Evidence” is a much narrower term. It includes only such proof as is admissible at trial by the act of the parties or through such concrete facts as witnesses, records, or other documents. Proof is the end result or effect of evidence, while evidence is the medium or means by which a fact is proved or disproved.
- (3) Direct evidence proves a fact, without an inference or presumption, and conclusively establishes that fact without reference to any supporting evidence. Direct evidence is evidence of the precise fact in issue and is distinguished from circumstantial i.e., “indirect,” evidence.
- (4) Tax crimes are often acts of individual greed and, therefore, very little “direct evidence” is usually available. Depending on the facts and circumstances of each investigation, the subject’s correct taxable income may be established by “direct” or several “indirect” methods of proof, usually using circumstantial or “indirect” evidence.

9.5.9.2.1

(11-05-2004)

**Direct (Specific Item)
Method**

- (1) Among the various methods of proving unreported or underreported taxable income, the specific item method is the most preferred. Most subjects report their income and expenses by the specific item method using books and/or records in which their financial transactions are contemporaneously recorded. Their transactions are usually summarized and shown on the tax return.
- (2) There are three broad categories of schemes which are suited to the specific item method of proof:
 - a. Understatement of income,
 - b. Overstatement of expenses,
 - c. Fraudulent claims for credits or exemptions.
- (3) A false tax return may include any or all of these schemes. Unreported Income can be proved using the basic or aggregate approaches discussed in the following subsections:
 - a. see IRM 9.5.9.4.3, How to Use the Specific Item Method of Proof,
 - b. see IRM 9.5.9.4.3.1, Basic Approach,
 - c. see IRM 9.5.9.4.3.2, Aggregate Approach.
- (4) Small amounts of expenses claimed on the false return sometimes have to be allowed or accepted because the special agent is unable to properly trace or document the actual amounts, or he/she lacks the time to do so.

9.5.9.2.2

(11-05-2004)

Indirect Methods

- (1) Indirect methods require the special agent to gather and present evidence to support the allegation. The special agent will use evidence to determine what income should have been reported on the subject's return and compare that to the amount shown on the return, if a return was actually filed.
- (2) Sources of income may not be identifiable, as in a specific item method of proof. Therefore, taxable income often has to be computed indirectly based upon the taxpayer's application or use of funds.
- (3) The courts have upheld the use of the net worth, expenditures, bank deposits and cash methods of proving income, on the theory that proof of unexpended funds or assets may establish a prima facie understatement of income which requires a defendant to overcome the logical inference drawn therefrom.
- (4) With respect to the establishment of a prima facie investigation by such evidence, courts have been careful to point out that findings of fraud have been sustained if, but only if, the defendant has offered no adequate explanation of the discrepancies between (on the one hand) expenditures, bank deposits, and increases in net worth and (on the other hand) the amount of income reported by the defendant.
- (5) Another indirect method of proof is the percentage markup method of proof. Pending the establishment of judicial precedents, the percentage markup method of proof should only be used as a primary method of proof, on a limited basis, and not used to corroborate other methods. (See IRM 9.5.9.9, Percentage Markup Method of Proving Income.)
- (6) The unit and volume method of proof can be utilized when the number of units handled and the price or profit charged per unit is known.

9.5.9.3
(11-05-2004)

Distinguishing Between Accounting Systems, Accounting Methods, and Methods of Proving Income

- (1) For many years, there has been much confusion regarding the synonymous use of the terms “accounting system,” “accounting methods,” and “methods of proving or determining income.” It is not unusual to hear reference made to the net worth and expenditures method as a method of accounting when, in fact, it is a method of proving income.
- (2) There are two basic accounting systems, i.e., the single entry system and the double entry system, but there are various methods of accounting, e.g., accrual, hybrid, installment, and long-term or completed contract methods. The most frequently used methods of proving or determining income are the specific item, net worth, expenditures, bank deposits, cash and percentage markup methods of proof.
- (3) For the purpose of criminal prosecution, taxable income must be computed by way of the accounting method regularly used by the subject to compute his/her income. In *Morrison v. United States*, 270 F. 2d 1(4th Cir. 1959), it was necessary to establish not only that the tax liabilities at issue were understated, but that the understatement was attributable, at least in part, to the fact that the subject’s returns were not honestly prepared. Proof of the latter fact could only be accomplished by adopting and consistently applying the subject’s method of accounting.
- (4) If no method of accounting has been regularly used by the subject, or if the method used does not clearly reflect income, special agents may use whichever method they believe clearly reflects the subject’s income. Whatever method is used, it must be used for all prosecution years.

9.5.9.4
(11-05-2004)

Specific Item Method of Proving Income

- (1) Where the government is using the specific item method of proof (in an investigation of alleged tax evasion), the government attempts to document specific transactions that were not completely or accurately reflected on the subject’s income tax return. Additionally, the government must show that the specific omissions of income were made willfully for the purpose of understanding the subject’s income tax liability.
- (2) The specific item method offers the most direct method of proving unreported income. The specific item method is the preferred method of proving income because it is the easiest to understand, include in a prosecution report, and present at trial. Additionally, the specific item of proof method is the hardest for the subject to rebut.

9.5.9.4.1
(11-05-2004)

Types of Evasion

- (1) Omitted income, fictitious deductions, false exemptions, or false tax credits are means whereby taxes may be evaded.
- (2) Omitted income results from a subject’s failure to report any of the numerous items of taxable income set forth in the Internal Revenue Code (IRC).
- (3) During investigations of proprietors and/or their businesses, sales or gross receipts are the most frequently encountered item of omitted income.
- (4) During investigations of individuals, omitted income is frequently encountered in the form of salaries, interest, dividends, commissions, gains from the sale of property, and fees.
- (5) Overstatement of expenses results from the subject’s attempt to reduce taxable income by claiming false or inflated expenses. During investigations of

proprietors and/or their businesses, overstated expenses can be hidden in any expense reported on the tax return. During investigations of individuals, the overstated expenses are most frequently encountered on Schedules A, C, D, and F. Additionally, subjects attempt to evade income taxes by claiming false deductions and exemptions. In all of the investigations described above, the specific item method of proof is ideally suited to proving the violation.

9.5.9.4.1.1
(11-05-2004)

**Unreported Income from
Certificates of Deposit**

- (1) There are two types of certificates of deposit, i.e., a standard certificate of deposit and an original issue discount certificate.

9.5.9.4.1.1.1
(11-05-2004)

**Standard Certificate of
Deposit**

- (1) A standard certificate of deposit pays interest at specific intervals over the term of the note.
- (2) Although the interest may be withdrawn without penalty, the principal normally may not be withdrawn without incurring a substantial penalty.
- (3) Financial institutions issue Forms 1099 INT to the owner reflecting the interest earned.

9.5.9.4.1.1.2
(11-05-2004)

**An Original Issue
Discount Certificate**

- (1) An original issue discount certificate pays interest only upon the note's maturity.
- (2) Title 26 USC 1272 requires holders of this type of certificate of deposit to report the interest earned on the basis of a constant interest rate.
- (3) Title 26 USC 6049 contains specifics as to when Form 1099—Original Issue Discount Certificates (OID) will be issued to holders of such certificates.

9.5.9.4.1.2
(11-05-2004)

**Department of Justice,
Tax Division's Position
on Original Issue
Discount Certificates**

- (1) The position of the Department of Justice (DOJ), Tax Division is that, except for unusual circumstances, it will not recommend the prosecution of criminal investigations which are based upon the subject's failure to report interest from original issue discount certificates before maturity, except under unusual circumstances.
- (2) In these investigations, a willfulness issue usually arises from the subject's lack of actual possession, use, and enjoyment of the interest during the holding period.
- (3) Similar problems should not arise in investigations involving standard certificates of deposit when the interest is made available to the subject.
- (4) When preparing a prosecution report proving the omission of income from a certificate of deposit, the special agent must properly identify the type of certificates of deposit in question. Copies of Forms 1099, as well as copies of the actual certificates of deposit, must be exhibited in the prosecution report.
- (5) In addition, the prosecution report should address the issue of willfulness by discussing whether the principal and interest on a matured certificate was rolled over into a new certificate of deposit, whether premature withdrawal of the principal is subject to penalties, and whether there was a premature redemption.

9.5.9.4.2
(11-05-2004)

**When to Use the
Specific Item Method of
Proof**

- (1) Specific omissions of gross income are most easily shown when the subject has a small number of significant sources of income. During the investigation, the special agent determines the specific amount of income reported from each source and then compares those figures with the total amount of income documented in the subject's books and records, and reported on his/her tax return. The following examples illustrate the appropriate use of the specific item method of proof:
 - a. While investigating a physician, the special agent found all receipts from patients had been reported but that amounts paid by insurance companies on behalf of patients were omitted. By contacting the various insurance companies, specific omissions of income were determined.
 - b. While investigating a self-employed subject who re-upholstered furniture, the special agent noted an inconsistency between reported income and living expenses. An analysis of reported gross receipts showed the subject reported small amounts of income received from individual customers. An analysis of the subject's bank records showed checks deposited from a large department store. Further investigation revealed that the subject failed to report substantial income earned on a contract basis with the department store.
- (2) When the subject of an investigation generates small amounts of income from numerous customers or clients, as would be the investigation with subjects owning bars, restaurants, and grocery stores, it is difficult, if not impossible, to match reported amounts of income with specific sources of income. In these situations the specific item method may not be the best method to use; indirect methods may be more appropriate.

9.5.9.4.3
(11-05-2004)

**How to Use the Specific
Item Method of Proof**

- (1) There are two approaches to the specific item method of proof, i.e., the basic approach and the aggregate approach. Depending upon the facts and circumstances of the investigation, the special agent will use one of the two approaches to prove unreported income.
- (2) The basic approach to the specific item method of proof requires the special agent to trace the reported items of income through the subject's books and records to the tax return. Upon doing so, the special agent can specifically identify the unreported income items.
- (3) The aggregate approach to the specific item method of proof simply requires that the special agent identify the total amount of income the subject should have reported in any given year. The special agent then compares the total amount of income with the aggregate amount of income reported on the return, and arrives at an understatement of income.

9.5.9.4.3.1
(11-05-2004)

Basic Approach

- (1) The basic approach to the specific item method of proof involves a two step process:
 - I. First, the special agent identifies the sources and amounts of reported income and expenses shown on the tax return by reconciling them to the subject's records.

II. Second, he/she determines the correct amounts of income, expenses, and credits using the subject's records, bank records, investment account records, and/or contacts with third parties and compares the correct amounts to those reported on the tax return. The comparison will yield specific items of unreported income and false or inflated expenses or credits.

- a. The reconciliation of reported gross receipts to the subject's records. In examining the return of a self-employed geologist, the special agent reconciles reported gross receipts with the subject's records as follows:

Source	Date	Amount	Total
Actor Company	01/27/1998	\$3,000.00	
Actor Company	08/14/1998	\$5,000.00	
			\$8,000.00
Barber Company	01/05/1998	\$6,000.00	
Barber Company	03/20/1998	\$4,000.00	
Barber Company	06/14/1998	\$2,000.00	
			\$12,000.00
Chef Company	05/01/1998	\$2,500.00	
Chef Company	07/22/1998	\$1,500.00	
			\$4,000.00
Total Reported Schedule C Gross Receipts			\$24,000.00

- b. Determine specific items of omitted income. By contacting each of the subject's three reported clients in the above example, the special agent was able to determine the correct income from those clients. An analysis of bank records disclosed a fourth customer, which the special agent also contacted.

Source	Date	Check No.	Amount Reported	Amount Omitted
Actor Company	01/27/1998	4517	\$3,000.00	
Actor Company	06/09/1998	6248		\$17,000.00
Actor Company	08/14/1998	9704	\$5,000.00	
Barber Company	01/05/1998	204	\$6,000.00	
Barber Company	03/20/1998	413	\$4,000.00	
Barber Company	06/14/1998	785	\$2,000.00	
Barber Company	10/14/1998	1032		\$19,000.00
Chef Company	05/01/1998	817	\$2,500.00	
Chef Company	07/22/1998	1042	<u>\$1,500.00</u>	
Chef Company	11/14/1998	1324		\$2,000.00
Driver Company	12/02/1998	205		<u>\$13,000.00</u>
Total Reported Schedule C Gross Receipts			<u>\$24,000.00</u>	
Total Omitted Schedule C Gross Receipts				<u>\$51,000.00</u>

9.5.9.4.3.2
(11-05-2004)

Aggregate Approach

- (1) When it is not possible to specifically identify the items of income which were not reported on a subject's tax return, due to a lack of accurate books and records, the special agent may use the aggregate approach to the specific item method of proof in calculating the subject's correct taxable income. This approach requires that the special agent specifically identify all of the subject's items of income and then compare that amount to the subject's total reported taxable income. For example, if the subject's return shows gross receipts of \$150,000, the special agent may develop a specific item investigation by showing through third-party documentation that the subject has actually received \$200,000 in gross receipts during the same period. The special agent does not have to identify the specific items of income that were not reported (\$50,000) as he/she has specifically identified the individual items that make up the gross receipts and determined that amount exceeds the aggregate

amount of gross receipts reported on the subject's income tax return. The following example will illustrate the aggregate approach to the specific item method of proof:

Example:

Gross Receipts Reported	\$150,000
<u>Receipts Documented by Third Party Contacts:</u>	
Witness A	\$ 50,000
Witness B	100,000
Witness C	50,000
Corrected Gross Receipts	\$200,000
Less: Reported Receipts	(150,000)
Equals: Unreported Gross Receipts	\$ 50,000

- (2) As shown by the above example, the special agent can use the aggregate approach and prove that gross receipts are understated without examining the subject's books and records. However, if the subject's books and records are available, the special agent must attempt to reconcile them to the tax return.

Note: The basic approach to the specific item method of proving income should be used whenever possible. The aggregate approach to the specific item method of proof should only be used when specific sources and amounts of income reported on a tax return cannot be identified.

9.5.9.5
(11-05-2004)
Net Worth Method of Proof

- (1) An investigation utilizing the net worth method of proof differs from a specific item method in that direct comparisons of income, expenses, and credits can not be made. The net worth method of proof utilizes evidence of income applications such as asset accumulation, liability reduction, expenditures, and other financial data to indirectly establish correct taxable income.
- (2) An accounting is made showing how funds generated from income were applied by identifying increases to net assets and various expenditures.
- (3) After making adjustments for exemptions, itemized deductions, nontaxable income, and nondeductible losses, the courts permit the IRS to infer, indirectly, that the remainder is taxable income.
- (4) By comparing this to taxable income reported on the subject's return, if a return was actually filed an understatement of taxable income can be determined.
- (5) The net worth method is a very effective way of proving taxable income in criminal income tax investigations. The formula for calculating the subject's correct taxable income can be broken down into four steps:
 - a. The special agent must first calculate the change in a subject's net worth (assets less liabilities). This is done by determining the subject's net worth at the beginning and end of a period of time (a taxable year or years) and then subtracting the beginning period's net worth figure from

the ending period's net worth figure. This computation will yield a change in net worth (either an increase or decrease in net worth).

- b. The amount of this change in net worth is then adjusted for personal living expenses, nondeductible losses, and nontaxable items to arrive at a corrected adjusted gross income figure.
- c. The corrected adjusted gross income figure is then adjusted for itemized deductions or the standard deduction amount, and then for exemptions, to arrive at a corrected taxable income figure.
- d. Finally, by comparing the corrected taxable income figure with the taxable income reported on the tax return, the special agent can determine whether the subject failed to report any taxable income.

9.5.9.5.1
(11-05-2004)

Authority for Net Worth Method

- (1) There is no statutory provision defining the net worth method and specifically authorizing its use by the Commissioner. However, every judicial circuit has endorsed the net worth method of proof and the Supreme Court has approved its use in a number of investigations. The following is a listing of some of the more prominent of those investigations:
 - a. *Holland v. United States*, 348 US 121 (1954),
 - b. *Friedberg v. United States*, 348 US 142 (1954),
 - c. *Smith v. United States*, 348 US 147 (1954),
 - d. *United States v. Calderon*, 348 US 160 (1954),
 - e. *Massei v. United States*, 355 US 595 (1958),
 - f. *United States v. Johnson*, 319 US 503 (1943).
- (2) These investigations outline the broad principles governing the prosecution and review of investigations based on the net worth method of proving income.

9.5.9.5.1.1
(09-03-2020)

Legal Requirements to Establish a Prima Facie Net Worth Investigation

- (1) The Supreme Court, while firmly approving the net worth method of proof, cautioned, in *Holland v. United States*, 348 US 121, 125 (1954), that "it is so fraught with danger for the innocent that the courts must closely scrutinize its use."
- (2) The Supreme Court set forth three requirements that the government must satisfy prior to using the net worth method of proof:
 - a. Establish an opening net worth with reasonable certainty,
 - b. Negate reasonable explanations by the subject inconsistent with guilt,
 - c. Establish that the net worth increase is attributable to currently taxable income - *Id.* at 132 - 137.
- (3) Net worth increases are determined by establishing a net worth at the beginning of a given year and then comparing this beginning net worth with the net worth at the end of the year. The opening net worth is the point from which net worth increases are measured. While every effort should be made to identify all of the assets and liabilities of the subject at the starting point, the government does not have to establish the opening net worth with mathematical certainty.
- (4) Without a doubt, determining how much cash an individual has "on hand" at the beginning or end of a year is an extremely difficult task. To require mathematical certainty would eliminate the possibility of using the net worth method of proof.

- (5) The thoroughness of the investigation is crucial in determining whether the government has established the subject's opening net worth with reasonable certainty. When the government chooses to proceed against a subject using the net worth method of proof, "the government assumes special responsibility of thoroughness and particularity in its investigation and presentation." *United States v. Hall*, 650 F. 2d 994, 999 (9th Cir. 1981).
- (6) Success in overcoming attacks on the legal sufficiency of the evidence supporting an opening net worth is directly related to the extent and thoroughness of the investigation. Although not a model, the Mastropieri investigation does furnish an excellent example of a number of steps that must be taken to establish an opening net worth. *US v Mastropieri*, 685 F. 2d 776, 779 (1982). For example, in Mastropieri:
 - The special agent canvassed 47 banks, 71 brokerage firms, and 13 lending institutions. In addition, the special agent searched the local property records of various counties for the years during the investigation and prior to 1967.
 - The special agent checked records of the IRS and the county clerk and interviewed unnamed friends and relatives of the subject.

9.5.9.5.2
(11-05-2004)
**When to Use the Net
Worth Method**

- (1) The net worth method of proof is most often used when one or more of the following conditions exist:
 - a. The subject maintains no books and records,
 - b. Books and records are not available,
 - c. Books and records are inadequate,
 - d. Subject withholds books and records.
- (2) The fact that the subject's books and records accurately reflect the figures on the return does not prevent the use of the net worth method of proof. The government can look beyond the self-serving declarations in the subject's books and records and use any evidence available to refute the accuracy thereof.
- (3) In addition to being used as a primary method of proving taxable income in civil and criminal income tax investigations, the net worth method can be used:
 - a. To corroborate other methods of proving income,
 - b. To verify accuracy of reported taxable income.

9.5.9.5.3
(11-05-2004)
Method of Accounting

- (1) The net worth method of proof is not limited by the subject's method of accounting. The net worth statement may reflect the subject's corrected taxable income by whichever method of accounting (cash, accrual, etc.) is appropriate. Reflecting a certain accounting method in the net worth computation is accomplished by including certain accounts in the net worth statement and omitting others. For instance, to compute the income of a physician on the cash basis, patient accounts receivable and business accounts payable at the beginning and end of each year would be omitted. If the physician used the accrual method of accounting, these accounts would be included in the net worth computation.
- (2) In preparing a net worth statement or summary for use in a criminal investigation, special agents should ensure that:
 - a. The subject's method of accounting is used.

- b. The cost of assets and actual amounts of liabilities are used and that values other than cost, i.e., market value or reproduction value, are not considered in the net worth computation.
- c. Estimated nondeductible expenditures are eliminated from the net worth computation, unless the subject agrees to the estimated amount or it is proper to include some minimum estimated personal living expense figures.
- d. Generally accepted accounting principles are followed.
- e. Technical adjustments that increase income are eliminated, e.g., unintentional errors or omissions relating to capitalized expenses, depreciation, revaluation of the basis of property, and changing inventory basis, or doubtful items such as unidentifiable commingled funds.

9.5.9.5.4
(11-05-2004)

**Overview of the Net
Worth Method of Proof
Formula**

- (1) The net worth formula expanded:

Assets:

Cash on hand
Cash in accounts
Checking
Savings
Brokerage
Securities
Vehicles (motor homes, airplanes, motorcycles, etc.)
Business equipment
Real estate investments
Personal items
Negotiable instruments

Subtract: Liabilities and Accumulated Depreciation

Loans
Notes
Accounts payable
Credit card
balances
Mortgages
Accumulated depreciation

Equals: Net Worth**Subtract: Prior Year's Net Worth****Equals: Increase (Decrease) in Net Worth****Add: Adjustments for Personal Expenditures and Nondeductible Losses**

Note: Personal living expenses (including payments that may later be allowed as itemized deductions or adjustments to arrive at adjusted gross income)

Federal income taxes paid
Life insurance premiums
Nondeductible portion of capital losses
Gifts of property made by subject
Losses on the sale of personal assets

Subtract: Adjustments for Nontaxable Items

Assets:

Federal tax refunds
 Gifts and inheritances received by subject
 Veteran 's benefits
 Nontaxable portion of pensions and annuities
 Tax-exempt interest
 Capital loss carryover
 Net operating loss carryover
 Honest mathematical and bookkeeping errors
 IRA and Keogh Plan payments
 Other nontaxable income

Equals: Corrected Adjusted Gross Income**Subtract: Allowable Itemized Deductions or Standard Deductions**

Personal exemptions

Equals:Corrected Taxable Income**Subtract: Reported Taxable Income****Equals: Unreportable Taxable Income**

- (2) In determining the value of assets, all assets in the computation are entered at cost or other tax basis. Fluctuations in fair market value are of no consequence in determining taxable income. Paper gains or losses resulting from changes in fair market value of assets are not taxable or deductible until said gain or loss is realized.

9.5.9.5.5
 (11-05-2004)

Establishing the Starting Point

- (1) The key to a successful net worth investigation is establishing a reliable beginning net worth (opening net worth) which includes all of the assets and liabilities on hand. It is this starting point from which all future increases or decreases will be calculated. This starting point is normally referred to as the base year. In a net worth computation, it is extremely important to firmly establish a beginning net worth (starting point or base year) with the best evidence available.
- (2) In calculating annual net worth, be aware that an inverse relationship exists between one year and the next. If the subject 's opening net worth is understated, there is a resulting overstatement of the increase in net worth for the following year. Conversely, if the subject's opening net worth is overstated, there would be a resulting understatement of the increase in net worth for the following year.
- (3) The first step to establishing a firm starting point is to determine the date (opening or base year) best suited for the investigation. The interview with the subject will strengthen the starting point. While questioning the subject, the special agent should attempt to develop all information relating to the subject's assets and liabilities for the years involved. The subject should be questioned

about the value of any item which cannot be determined from available books and records, e.g., cash on hand as of a particular date, personal living expenses, assets held in the names of others, gifts, inheritances, loans, and other nontaxable sources of income.

- (4) The establishment of cash on hand is critical. The inability to establish a firm and accurate amount of cash on hand can be fatal to the investigation. Uncertainty about the amount of cash on hand is a common defense in net worth investigations. It will be easier to refute this defense if the special agent has established a firm beginning and an ending cash on hand amount is established. Cash on hand is almost always proved by circumstantial evidence.
- (5) The best source of information in establishing an accurate cash on hand figure may be obtained from the subject during an interview. The special agent may not always have the opportunity to interview the subject in every investigation. However, when the opportunity does exist, the special agent should attempt to establish the beginning and ending cash on hand. In determining a firm cash on hand figure, the following subsections offer insight into possible techniques to employ during a subject interview.
- (6) During the subject interview, the subject should be questioned in detail about cash on hand. The questioning should be preceded with an explanation of what constitutes cash on hand and elicit the subject's answer as to cash on hand. Cash on hand is coin and currency (bills, Federal Reserve notes, etc.) in the subject's possession, i.e., on the subject's person, in the subject's residence, or other place, in nominee hands, or in a safe-deposit box. It does not include any money the subject has on deposit in any account with any type of financial institution.
- (7) The special agent should use caution in using terms such as cash because people often refer to money on deposit in banks as cash on hand. The special agent should be specific and explain that he/she is referring to undeposited coin and currency in all locations.
- (8) Most people have difficulty recalling specific dates and amounts, especially when several dates are involved, and they extend back for a number of years. Direct questions, such as "How much cash on hand did you have on December 31, ____" will frequently be answered with "I don't know" or "I can't remember that far back". In such investigations, the special agent should persist in questioning about whether the subject had a depository for coins or currency and/or whether the subject placed any coins or currency in the possession of another person. The special agent should obtain a description of the depository. If the depository is a safe-deposit box or home safe, the special agent should relate the questions to when and where the box was rented or purchased. The special agent should obtain a description of the depository and a description of the funds (their denomination and quantity) to determine whether it was possible to have such a sum of money in that particular depository.
- (9) The special agent may determine the amount of cash on hand by asking questions about the maximum amount of cash that the subject could possibly have had at any particular time. For example, such questions as, "Did you ever have more than \$100 in cash on hand? More than \$5,000? More than \$10,000?" may result in admissions that can establish the total amount of cash on hand at a particular date.

- (10) Discussing the accumulation and purpose of the cash on hand may establish the minimum and maximum amount on a particular date. Determining the ultimate disposition of this cash on hand can provide a lead to a specific amount of cash on hand on a particular date. For example, a statement like "I used all my cash on hand to pay for my house in 1994" indicates how much cash the subject had on the date of payment. It also provides a cut-off date for cash on hand, since the subject evidently had no more cash after using all the cash on hand to pay for the house. The special agent should question the subject further to elicit an admission that the subject did not have any additional cash on hand as of the specified date.
- (11) The special agent's questioning should be directed toward developing:
 - a. The maximum amount of cash on hand (undeposited currency and coin) claimed at the starting point and at the end of each year under investigation,
 - b. The amount of cash on hand at the date of the interview (This data is sometimes useful in computing cash on hand for earlier years.),
 - c. How was the cash on hand accumulated and from what sources,
 - d. Where the cash was kept,
 - e. Who knew about the cash,
 - f. Whether anyone ever counted the cash,
 - g. When, where and for what was any cash spent,
 - h. Whether any record is available with respect to the alleged cash on hand,
 - i. The denominations of the cash on hand,
 - j. Was the cash shown on any net worth or personal financial statements,
 - k. Ask to see the cash on hand.
- (12) In addition to questioning the subject about cash on hand, also:
 - a. Question the subject about prior years' earnings,
 - b. Obtain prior years' tax returns to determine if no return was filed or if the returns indicate little or no income in prior years,
 - c. Determine if the subject had financial difficulties prior to the starting point, e.g., compromises of overdue debts by the subject; foreclosure procedures against the subject; collection actions against the subject, etc.,
 - d. Obtain copies of financial and or net worth statements,
 - e. Question the subject as to the contents of any safe-deposit boxes,
 - f. Question the subject concerning all taxable and nontaxable sources of income,
 - g. Obtain loan records,
 - h. Determine consistent use of checking and savings accounts,
 - i. Determine if there are recurring overdrafts on non-sufficient funds (NSF) charges or other bank penalties,
 - j. Determine the minimum payments on any credit card balances,
 - k. Determine if there was ever a divorce and division of assets.
- (13) In addition to interviewing the subject, the following investigative steps should be taken when establishing a firm starting point in a net worth investigation:
 - a. The special agent should interview the subject's spouse, relatives, and close associates to determine if the subject received loans, gifts, or inheritances in prior years. The interview of the subject's spouse should

- include cash on hand and sources of taxable and nontaxable income so that the subject cannot claim the increases resulted from funds the spouse received.
- b. The special agent should canvass banks and stockbrokers to determine whether the subject has or had any accounts that could be a source of funds, or whether he/she submitted any financial statements to the financial institution. When reviewing bank records, the special agent should determine whether the subject has ever had checks returned for insufficient funds.
 - c. The special agent should examine financial statements presented for credit or other purposes at a time prior to or during the periods under investigation. The special agent can obtain these types of documents from banks, loan companies, bonding companies, and the other operating divisions of the IRS (offers in compromise and financial statements).
 - d. The special agent should check the following records for potential assets, liabilities, and sources of funds:

Real estate records to determine if the subject owns or has owned property that could be a source of funds,

Bankruptcy, foreclosure, and repossession record (If the subject filed for bankruptcy, this could be used as a starting point for net worth),

Divorce records,

Social security records for prior earnings and receipt of any funds from social security,

Welfare records,

Probation records.

- e. The special agent should determine the subject's borrowing habits, especially borrowing at high interest rates.
- f. The special agent should analyze available Federal and state tax returns. Tax returns can be obtained from the IRS, the state where the subject resided, the subject's accountant and/or return preparer, or financial institutions where the subject has applied for and/or obtained loans.
- g. In the event the special agent is unable to firmly establish a starting point through the above-described steps, the special agent may have to rely upon an indirect approach to establishing a starting point. This can be accomplished by using a Source and Application of Funds computation.

9.5.9.5.5.1
(11-05-2004)

**An Indirect Approach for
Establishing a Starting
Point**

- (1) Another method of establishing a starting point for cash on hand is to analyze the subject's available finances for the years leading up to the starting point. Such a "source and application of funds" approach can also be used to bridge the years to the starting point from some point in time when cash on hand has been firmly established. The following is an example of how a source and application of funds computation can be used to establish a firm starting point in a net worth investigation.
 - a. The subject filed bankruptcy in 1993. Immediately following the bankruptcy, the subject did not have any assets or liabilities. The starting point for the investigation is December 31, 1996, the prosecution years are 1997 and 1998. For the purposes of using the source and application of

funds computation in determining a firm starting point (cash on hand figure on December 31, 1996), the years 1993 through 1996 would be treated as one unit.

- (2) First, the special agent must determine the total amount of funds available (taxable and nontaxable) during 1993 through 1996. From this amount, he/she will subtract the subject's personal expenditures for the period. This will yield the maximum amount of funds available for the subject's net worth at the beginning of 1997.
- (3) Second, the special agent subtracts the subject's beginning net worth figure (the amount the investigation revealed as of December 31, 1996, without the cash on hand figure) from the total funds available for net worth. This will account for non-personal living expenditure payments by reflecting the payments made to increase assets and decrease liabilities.
- (4) Funds used to purchase assets disposed of prior to the starting point can be included as funds applied, if their disposition is traced and the funds from the disposition are accounted for as funds available. The advantage of using this method is that the beginning net worth can be used as funds applied. If the subject has a large beginning net worth, it may be possible to overcome the subject's reported income for prior years and show that he/she could not have had cash on hand at the starting point. This can also be used to establish a maximum possible cash on hand figure. It is important that the subject be given credit for all sources of funds available (both taxable and nontaxable) in the period for which the source and application method is used.
- (5) When using the one unit source and application of funds method to establish a firm starting point, the beginning net worth must be adjusted for any asset purchased and completely paid for prior to the source and application years. This is necessary because no funds were applied during the source and application period to purchase the asset. This point is illustrated in the following example:
 - a. The subject purchased and paid off a residence 10 years prior to the starting point. The cost of the residence \$20,000, is included in the beginning net worth. The source and application of funds only covers a period of six years prior to the starting point. The beginning net worth must be adjusted by subtracting the cost of the residence because the residence was purchased with funds acquired by the subject prior to the years included in the computation. This is illustrated as follows:

Funds available (1991–1996)	\$105,000
Less: Funds applied to personal living expenses	-50,000
Equals: Maximum funds available for an increase in net worth	<u>55,000</u>
Beginning net worth per investigation	\$72,000
Less: Cost of residence purchased prior to 1991	-20,000
Funds applied by the subject to acquire the adjusted beginning net worth	<u>\$52,000</u>
Maximum funds available for an increase in net worth	\$55,000
Less: Funds applied by the subject to acquire the adjusted beginning net worth	-52,000
Equals: Maximum possible cash on hand at starting point 12/31/1996	<u>\$ 3,000</u>

- (6) This method can be used to establish cash on hand at the starting point if the subject does not cooperate during the investigation, or to corroborate the subject's admission of cash on hand. A source and application of funds cannot be used in every investigation but, in certain instances, can be a valuable tool in determining possible cash on hand.

9.5.9.5.5.2
(11-05-2004)
Presenting Cash on Hand Figures

- (1) As mentioned earlier, the cash on hand figure is often the most difficult item to establish. Whenever possible, it is best to establish specific cash on hand figures for each year. However, after exhausting all of the various leads, contradictions may still exist or the special agent may have no specific information at all. In order to work around this issue, approximate figures are often used; however, this may not be the best solution. In investigations where no cash on hand information can be found, the special agent can enter beginning cash on hand as zero.

9.5.9.5.5.3
(03-22-2005)
The Dash Theory

- (1) In situations where the subject had some available currency which was used in previously identified currency transactions, a constant figure of an unknown amount represented by a dash (-) can be used in a net worth calculation to symbolize cash on hand.
- (2) The dash (-) indicates that the "inventory" of undeposited coin and currency cannot be quantified, but that facts and circumstances, *i.e.*, evidence in the investigation, indicate that cash on hand or inventory of undeposited currency either remained constant or increased during the period. *United States v. Giacalone*, 574 F.2d 328, 333 (6th Cir. 1978) ("The recognition of a cash bankroll treated as a constant, together with proof which would support a finding that no significant cash hoard existed, [is] a sufficient accounting for cash in the opening net worth computation.") See also *United States v.*

Sabino, 274 F.3d 1053, 1072 (6th Cir. 2001). The Sixth Circuit makes clear the dash method cannot be used to overcome the defense of a cash hoard, or as a way to avoid determining an opening balance of cash on hand.

9.5.9.5.6

(11-05-2004)

Taxable Source of Income

- (1) In order for income to be taxable, it must come from a taxable source, *Commissioner v. Glenshaw Glass Co.*, 75 S. Ct. 473 (1955). In the *Holland* investigation, the Supreme Court opined that, an "Increase in net worth, standing alone, cannot be assumed to be attributable to currently taxable income. But proof of a likely source, from which the jury could reasonably find that the net worth increases sprang, is sufficient. . ." *Holland*, supra at 138.
- (2) Following the *Holland* decision, it appeared that proof of a likely source was necessary in every net worth investigation. This premise was clarified by the Supreme Court in *United States v. Massei*, 78 S. Ct. 495 (1958) when it stated:

In *Holland* we held that proof of a likely source was "sufficient" to convict in a net worth investigation where the government did not negate all the possible nontaxable sources of the alleged net worth increases. This was not intended to imply that proof of a likely source was necessary in every investigation. On the contrary, should all possible sources of nontaxable income be negated, there would be no necessity for proof of a likely source.

- (3) In view of these decisions, it appears that the government must either prove a likely source of taxable income or negate all nontaxable sources of income. In investigations where the government resorts to negating all nontaxable sources of income, it is even more critical to establish a firm starting point, particularly with reference to cash on hand.
- (4) Proof of a likely taxable source of income has been found sufficient in a number of criminal investigations by:
 - a. Showing that the subject did not report certain income on the tax returns. *United States v. Chapman*, 168 F. 2d 997 (7th Cir 1948).
 - b. Showing that the subject did not report certain income for years prior to indictment period. *United States v. Skidmore*, 123 F. 2d 604 (7th Cir 1948).
 - c. Comparing the business operations and profits of the subject for the years under investigation with profits or prior operations for a comparable period. In the *Holland* investigation, the Supreme Court pointed out that the business of the defendant, a hotel, apparently increased during the years in question, whereas the reported profits fell to approximately one quarter of the amount declared by the previous management in a comparable period.
 - d. Effectively contradicting the subject's assertions as to nontaxable sources.
 - e. Opportunities of the subject to receive graft.
 - f. The nature of the business has the capacity to produce income in amounts determined by the net worth method.
- (5) A likely source of income is established in net worth investigations by showing the source of income identified by the subject had the potential to produce income substantially in excess of that reported.

- (6) Negating nontaxable sources of income may be accomplished by substantiating the subject's admissions as to the receipt or non-receipt of loans, gifts, and inheritances. If the subject alleges to have received nontaxable sources of income, the special agent should verify the claim by reviewing Federal gift tax returns filed by the alleged donor or probate records of the deceased relatives' estates. Additionally, the special agent should interview the person who allegedly made the gift to the subject. However, if the subject advances a specific explanation as to the sources of nontaxable funds expended, the government does not have to pursue other possible nontaxable sources of income when the one given is proven false.

9.5.9.5.7
(11-05-2004)
Investigation of Leads

- (1) When a subject offers leads or information during a net worth investigation that, if true, would establish his/her innocence, such leads must be pursued. This also applies if the subject offers leads or information after the completion of an investigation but within sufficient time before trial.
- (2) During the trial, if the government fails to show an investigation into the validity of the leads provided by the subject, the trial judge may consider the defendant's information as true and the government's investigation insufficient to go to the jury.
- (3) Most leads refer to cash hoards, gifts, inheritances, and loans. These leads should be checked as routine steps taken during the investigation.
- (4) The courts have held that the government does not have to investigate leads that are not reasonably verifiable. This is a question of judgment and, in the final analysis, is always a matter for the court to determine.

9.5.9.5.8
(09-03-2020)
**Summaries and
Appendices Prepared by
the Special Agent**

- (1) In investigations utilizing a detailed computation of net worth, the factual data may be best presented via a summary of the details broken down into at least one main appendix and various sub-appendices.
- (2) An appendix is a document developed to summarize and present, in a concise manner, voluminous information that is contained in the exhibits of an investigation. A sub-appendix supports the main appendix and is generally prepared when there are a number of items of a particular type of asset, liability, or other adjustment. Sub-appendices are also used when there are numerous witnesses or exhibits to support a particular net worth item. Keep the main appendix as simple and brief as possible to aid in its presentation and clarity. While there is no set format for a sub-appendix, it should be organized in a manner which presents the information in a clear and concise manner.
- (3) A copy of each appendix and sub-appendix must accompany each copy of the final prosecution report. The exhibits to the investigation accompany only the original report. If sub-appendices are used, they must refer to the proper witness, the exhibit number, and a description of the evidence used to support the item.
- (4) Sub-appendices are prepared to summarize the pertinent information that is found in the exhibits. The totals from the sub-appendices are forwarded to the main appendix, where the information is summarized. The main appendix is then cited in the body of the final report. Multiple main appendices are common in net worth investigations.

- (5) During a trial of an income tax investigation involving the net worth method of proving taxable income, the special agent may introduce the sub-appendices and main appendix used to support the final report. It is important to remember that the special agent's work product (main appendix and supporting sub-appendices) is not evidence. These schedules and appendices should summarize documents and testimony already admitted into evidence during the trial. These schedules and appendices are admitted for the purpose of aiding and assisting the jury in considering the evidence admitted. The admissibility and use of appendices and summaries are discussed in IRM 9.6.4, Trial.
- (6) In addition to appendices, schedules, and summaries, net worth computations have been presented to the jury through the use of graphs and charts.

9.5.9.5.8.1
(11-05-2004)

Adjustments to Net Worth

- (1) After the special agent has established a firm starting point and identified the amount of cash on hand, the next step is to calculate the subject's change in net worth for the prosecution years. Once the change (increase or decrease) in the subject's net worth has been determined, the special agent makes adjustments to that figure and arrives at the subject's corrected adjusted gross income. Perhaps the most difficult phase in calculating a subject's corrected taxable income is identifying, documenting, and correctly applying the adjustments to the subject's change in net worth for the nondeductible and nontaxable items. These adjustments are necessary in arriving at the subject's corrected adjusted gross income figure from the calculated increase or decrease in net worth. The following paragraphs will identify common adjustments to the calculated increase or decrease in a subject's net worth.
- (2) The following are examples of adjustments for personal expenditures and non-deductible items which are added to the subject's change (increase or decrease) in net worth:
 - a. Personal living expenses,
 - b. Federal tax payments,
 - c. Nondeductible portion of capital loss,
 - d. Losses on sale of personal assets,
 - e. Gifts made,
 - f. Life insurance premiums.
- (3) The following are examples of adjustments for nontaxable items which are subtracted from a subject's change (increase or decrease) in net worth:
 - a. For capital gain transactions see the appropriate instructions and forms for statutory inclusions and exclusions,
 - b. Gifts received,
 - c. Inheritances,
 - d. Nontaxable pensions,
 - e. Veterans benefits,
 - f. Non-taxable portion of social security income,
 - g. Tax exempt interest,
 - h. Proceeds from life insurance,
 - i. Disability income received (USC 104–106),
 - j. Errors in subject's records (in his favor) which relate to honest mathematical and bookkeeping errors found in the subject's books and records, and which tend to account for part of the understated income,

- k. Gains on the sale of a personal residence (depending upon the date of the sale, the gain could be entirely non-taxable) pursuant to the applicable law concerning these transactions and to the extent of whatever non-taxable gain the subject may have received,
 - l. Net operating loss carry-back and carry-forward,
 - m. Allowed capital loss carry-over,
 - n. Federal income tax refunds.
- (4) No adjustment is necessary to net worth increase or decrease for:
- a. Net short-term capital gain,
 - b. Deductible portion of net short-term capital loss,
 - c. Excess of net short-term capital gain over net long-term capital loss.

9.5.9.5.8.2
(11-05-2004)
**Adjustments to
Corrected Adjusted
Gross Income to
Calculate Corrected
Taxable Income**

- (1) The adjustments to corrected adjusted gross income are the standard or itemized deductions and the personal exemptions.
- (2) Due to the calculated increase in adjusted gross income, the special agent should increase the itemized deductions for items allowed which the subject failed to claim. Likewise, the special agent should also decrease the itemized deductions for threshold items affected by an increase in adjusted gross income.
- (3) Corrected adjusted gross income less the itemized deductions and personal exemptions results in the subject's corrected taxable income. When the taxable income that was reported on the income tax return is deducted from the corrected taxable income, the final figure is additional taxable income based on the net worth method of proof.

9.5.9.5.9
(11-05-2004)
**Common Defenses in
Net Worth Investigations**

- (1) Special agents can overcome the following common defenses in net worth investigations by thoroughly investigating them at the onset of the investigation.

9.5.9.5.9.1
(11-05-2004)
Lack of Willfulness

- (1) Defense counsel usually contends there is no evidence of willfulness. This contention may be overcome by evidence outlined in IRM 9.1.3, Criminal Statutory Provisions and Common Law.

9.5.9.5.9.2
(11-05-2004)
Cash on Hand

- (1) The subject usually claims that there was a large amount of cash on hand which the government has not considered in the beginning net worth. The subject also may claim that cash balances are wrong for years subsequent to the base year.
- (2) In all investigations where the net worth method is the primary method of proving income, the special agent should anticipate this defense and accurately establish the cash on hand figure for the starting point and throughout the prosecution years to negate this defense.
- (3) Admissions by the subject are most effective to determine the cash on hand amount and should be obtained during the initial interview or early in the investigation. (See IRM 9.5.9.5.5, Establishing the Starting Point.)
- (4) In most investigations, the subject's spouse should also be questioned about cash on hand, as well as other matters. In order to avoid any misunderstanding-

ing by the subject, it is suggested that the meaning of cash on hand be explained prior to discussing the matter.

- (5) The subject (and spouse) should be questioned regarding their financial history from the time they were first gainfully employed. This information will serve in many investigations to check the accuracy of the subject's statements about cash on hand.
- (6) In addition to admissions, evidence used to establish the beginning net worth will most often be sufficient to refute the defense of cash on hand.

9.5.9.5.9.3
(11-05-2004)
**Failure to Adjust for
Nontaxable Income**

- (1) The usual sources of nontaxable income claimed by the subject are gifts, loans, and inheritances. Negating evidence of the type will often be sufficient to overcome these claims as described in the subsections listed below:
 - a. see IRM 9.5.9.5.6, Taxable Source of Income,
 - b. see IRM 9.5.9.5.7, Investigation of Leads.

9.5.9.5.9.4
(11-05-2004)
Inventories Overstated

- (1) Special agents should not rely upon inventory figures on the subject's returns as prima facie evidence to establish the values of assets in the net worth computation. Some subjects, either through ignorance or for other reasons, report inventory at retail value instead of at cost or some other value. (In a net worth computation where the assigned value of the inventory used exceeds cost and is larger at the end of the investigative period than the beginning, income will be overstated.) To resolve this, the special agent should attempt to corroborate the inventory figures shown on the subject's returns by admissions of the subject, statements of employees who took the inventory, copies of inventory records, amounts shown on state or local property tax returns, etc.

9.5.9.5.9.5
(11-05-2004)
**Holding Funds or Other
Assets as Nominee**

- (1) In certain investigations, a subject may falsely claim to be holding, as nominee of another (usually unidentified) individual, funds or other assets the government included in the subject's net worth computation. Special agents should interview the subject about this matter in the early stages of the investigation.

9.5.9.5.9.6
(11-05-2004)
**Net Operating Loss
Carry-Forward**

- (1) This defense is usually based upon a net worth computation of taxable income made by the subject's accountant for years prior to the starting point. This computation will show an operating loss prior to the prosecution. The defense strategy is to carry forward the loss to the prosecution years and reduce the alleged tax deficiency as much as possible.
- (2) To overcome this defense, special agents should make a net worth determination of income for several years prior to the prosecution period and then on the basis of this computation either:
 - a. Allow the carry-forward loss, or
 - b. Show the incorrectness of the accountants' determination.

9.5.9.5.9.7
(11-05-2004)
False Loans

- (1) The objective of this defense is to reduce taxable income by claiming nonexistent loans, usually from the subject's friends or relatives. This defense may be overcome by showing that the alleged lender was financially unable to lend the amount claimed. The special agent should attempt to obtain and then corroborate the details of the claimed loans by interviewing the individuals who allegedly made the loans to the subject.
- (2) The matter of loans should be covered during the initial subject interview.

9.5.9.5.9.8
(11-05-2004)
**Jointly Held Assets of
the Subject and Spouse**

- (1) In some investigations, the subject and spouse may report income on separate returns, but assets they acquired are held jointly. If the jointly held assets are included in the net worth computation, the claim may be made that they were acquired with the spouse's income.
- (2) This defense can be overcome by tracing the invested funds back to the subject and showing the disposition of the spouse's income.
- (3) There may be investigations in which the funds of the subject and spouse are so intermingled that it is not possible to trace the invested or applied funds to either party. In such investigations, use the net worth method of proof to determine the corrected taxable income of both the subject and the spouse, and then deduct the taxable income of the spouse to arrive at the subject's corrected taxable income.
- (4) There are several states that have community property statutes. Under community property laws, income, assets and liabilities are equally divided between spouses. If the subject and/or his/her spouse reside in a community property state, the appropriate laws must be applied to compute the subject's income, expenses, assets, and liabilities.

9.5.9.6
(11-05-2004)
**Expenditures Method of
Proving Income**

- (1) The expenditures method of proving income utilizes circumstantial evidence, i.e., several material facts which, when considered in their relationship to each other, tend to establish the existence of the principal fact, to establish a subject's understatement of taxable income. The expenditures method of proof is, in theory, closely related to, if not identical to, the net worth method of proof. This method is based on the theory that if the subject's expenditures during a given year exceed his/her reported income, and the source of the funds used to make the expenditures is unexplained, it may be inferred that such expenditures represent unreported income.
- (2) The similarity between the net worth and expenditures methods of proof is further demonstrated by the fact that the same items or accounts used in determining taxable income by the net worth method are also considered when the expenditures method is employed.
- (3) Judge Goodrich defined the Expenditures Method of Proof in *United States v. Caserta*, 199 F. 2d 905, 907 (3d Cir 1952), as follows:

It starts with an appraisal of the subject's net worth situation at the beginning of a period. He may have much or he may have nothing. If during that period, his expenditures have exceeded the amount he returned as income and his net worth at the end of the period is the same as it was at the beginning (or any difference accounted for), then it may be concluded that his income tax return shows less income than he has in fact received. Of course it is necessary, so far as possible to negate nontaxable receipts by the subject during the period in question.

9.5.9.6.1
(11-05-2004)

Authority for Using the Expenditures Method

- (1) Like the net worth method, there is no statutory provision defining the expenditures method of proof and expressly authorizing its use by the Commissioner. There are, however, many investigations in which the courts have approved the use of this method. The following is a list of some of the more prominent investigations:
 - a. *United States v. Johnson*, 319 US 503, 517 (1943),
 - b. *United States v. Caserta*, 199 F. 2d 905, 907 (3d Cir. 1952),
 - c. *Taglianetti v United States*, 398 F. 2d 558, 565 (1st Cir. 1968), *aff'd*, 394 US 316 (1969) .
- (2) These investigations outline the broad principles governing the prosecution and review of investigations based on the expenditures method of proving income.

9.5.9.6.2
(11-05-2004)

When and How the Expenditures Method is Used

- (1) The expenditures method of proof is used when the subject's net worth does not substantially increase during the period under investigation, or when significant extravagant living expenditures are apparent. Therefore, when a subject has spent substantial income on consumable goods and services such as food, vacations, travel, gifts to third parties, etc., as opposed to durable and tangible property such as stocks, bonds, or real estate, the expenditures method of proof would be an appropriate method of proving income.
- (2) In investigations where the subject has several assets (and liabilities) whose cost basis remains the same throughout the prosecution period, the expenditures method may be preferred over the net worth method because a more concise presentation can be made of the computation of taxable income. This is true because assets and liabilities which do not change during the investigation period may be omitted from the expenditures statement.
- (3) The expenditures method is used most often in investigations where the subject spends income to support a lavish life-style and has little, if any, net worth.
- (4) In an expenditures investigation, it is desirable to prepare a complete net worth statement which may be required to rebut a defense that the funds in question came from the conversion of some asset not considered in the expenditures computation.
- (5) In submitting a prosecution report based upon an expenditures investigation, the special agent should also submit proof of the subject's unreported taxable income using the net worth method of proof. Because these two methods of proof are so similar, in that they require the same investigative steps be taken, proving unreported income through both methods substantially strengthens the prosecution recommendation.
- (6) If both methods are shown, the trial attorney can make the final decision as to which method of proof best presents the investigation to the jury.

9.5.9.6.3
(11-05-2004)

The Expenditures Method of Proof Formula

- (1) The expenditures method of proof formula is as follows:

	Expenditures (Money Spent or Applied)
Less:	<u>Non-Taxable Sources of Funds</u>
Equals:	Corrected Adjusted Gross Income
Less:	<u>Itemized/Standard Deduction</u> <u>Personal Exemptions</u>
Equals:	Corrected Taxable Income
Less:	<u>Reported Taxable Income</u>
Equals:	Additional Taxable Income (Unreported Income)

9.5.9.6.4
(11-05-2004)

Establishing the Starting Point

- (1) To establish a starting point, the subject's assets at the beginning of the tax periods under investigation should be identified and monitored to determine if any assets were converted for use as personal expenditures.
- (2) While establishing a starting point, special agents may prefer to use a net worth analysis, depending upon the facts and circumstances surrounding the investigation. (See IRM 9.5.9.5.5, Establishing the Starting Point.)

9.5.9.6.5
(09-03-2020)

**Expenditures
Summaries Prepared by
the Special Agent**

- (1) The following steps have been found helpful in the preparation of an expenditures statement:
 - a. Prepare a net worth statement.
 - b. Determine the amount of increase or decrease in each asset and liability appearing on the net worth statement in each taxable year (for instance, if the beginning and ending bank balances for a taxable year were \$4,500 and \$150, respectively, it would be determined that this asset has decreased by \$4,350. The amounts so determined and the amounts appearing as adjustments to net worth increases or decreases are then posted to the expenditures statement.)
- (2) Money spent or applied on nondeductible items, i.e., personal living expenses, Federal income tax payments, etc., should be posted to the following sections:
 - a. Increase in assets,
 - b. Decrease in liabilities.
- (3) Nontaxable source items i.e., gifts, inheritances, etc., received by subject should be posted to the following sections:
 - a. Decrease in assets,
 - b. Increase in liabilities.

9.5.9.6.6
(11-05-2004)

**Defenses in
Expenditures Method
Investigations**

- (1) The defenses regarding the net worth method of determining income are equally applicable to the expenditures method. (See IRM 9.5.9.5.9, Common Defenses.)

9.5.9.7

(11-05-2004)

**Bank Deposits Method
of Proving Income**

- (1) The bank deposits method of proving income utilizes bank account records to establish a subject's understatement of taxable income. When there is no, or insufficient, direct evidence of income and/or expenses, the government can still make its investigation indirectly through the use of circumstantial evidence.
- (2) The theory behind the bank deposits method of proof is simple. There are only three things a subject can do with money once it is received, i.e., he/she can spend it, deposit it, or hoard it. Accounting for these three areas considers all funds available to the subject. If non-income sources are eliminated, the remaining currency expenditures, deposits, and increases in cash on hand will equal corrected gross income.
- (3) The bank deposits method of proof requires the special agent to conduct a thorough analysis of the deposits and canceled checks which relate to any and all bank accounts controlled by the subject. Additionally, the special agent must document the subject's currency expenditures and cash on hand.
- (4) If the subject reported income on the accrual basis, adjustments should be made in the bank deposits method to reflect accrued income and expenses.
- (5) The following represents an overview of the bank deposits method of proof formula. This particular overview illustrates the steps taken if the subject had business income and expenses.

Total Deposits \$

Add:

Currency Expenditures
Increase in Cash on Hand

Subtract:

Non-Income Deposits and Items

Equals:

SUBTOTAL

Subtract:

Cost of Goods Sold

Equals:

GROSS INCOME

Subtract:

Business and Rental Expenses

Equals:

TOTAL INCOME

Subtract:

Adjustments to Income

Equals:

ADJUSTED GROSS INCOME

Subtract:

Personal Deductions and Exemptions

Equals:

CORRECTED TAXABLE INCOME

Subtract:

Taxable Income Reported

Equals:

ADDITIONAL TAXABLE INCOME

9.5.9.7.1
(11-05-2004)
**Authority for Bank
Deposits Method**

- (1) There is no statutory provision defining the bank deposits method of proving income and specifically authorizing its use by the Commissioner. The bank deposits method of proof is not defined by the USC or regulations. It is primarily based upon the Supreme Court's decision in *Gleckman v. United States*, 80 F. 2d 394 (8th Cir. 1935), which affirmed a lower court ruling that recognized the bank deposits method as an acceptable method of proving income.

9.5.9.7.1.1
(11-05-2004)
**Legal Requirements to
Establish a Prima Facie
Bank Deposits
Investigation**

- (1) As a result of the *Gleckman* decision, the following evidentiary facts are used to establish a prima facie bank deposits investigation:
 - a. The subject was engaged in an income-producing business, activity, or profession.
 - b. The subject made periodic deposits of funds into his/her bank accounts, or into nominee bank accounts over which he/she exercised control.
 - c. The deposits into the above referenced accounts reflect current year income and an adequate investigation of deposits was made by the investigating special agent to negate the possibility that deposits arose from nontaxable sources.
 - d. Unidentified deposits have an inherent appearance of income.
- (2) The fact that a subject deposited a sum of money in a bank account does not prove the funds deposited therein were taxable. The fact that the subject received and cashed a large check, in and of itself, does not prove the funds received were taxable. In order to establish those funds represented taxable income, the following must be shown:
 - a. The subject has a business or other regular income source.
 - b. The subject made regular deposits into an account.
 - c. The subject draws against the account for personal use.
 - d. There is testimony that the subject has income.
 - e. Deposited amounts exceed exemptions and deductions.
- (3) The courts have held there is no necessity to disprove the accuracy of the subject's books and records as a prerequisite to the use of the bank deposits method.

9.5.9.7.2
(11-05-2004)
**When to Use Bank
Deposits Method**

- (1) The bank deposits method of proof is recommended as the primary method of proof when:
 - a. The subject's books and records are not available.
 - b. The subject's records are not complete and do not adequately reflect their correct income.
 - c. The subject deposits most of his/her income and uses bank deposits to calculate gross receipts on their return.
- (2) In addition to being a primary method of proving income, the bank deposits method is also used to corroborate other methods of proof and to test-check the accuracy of reported taxable income.

9.5.9.7.3
(03-19-2012)

Method of Accounting

- (1) The use of the bank deposits method of proof is not affected by the subject's method of accounting. The bank deposit analysis may reflect the subject's corrected taxable income by whichever method of accounting is used by the subject. Reflecting a certain accounting method in the bank deposit computation is accomplished by including certain accounts in the bank deposit analysis and omitting others. For instance, to compute the income of a physician who uses the cash basis method, patient accounts receivable and business accounts payable at the beginning and end of each year would be omitted. If the physician used the accrual method of accounting, these accounts would be included in the bank deposit analysis.
- (2) When a subject reports income on the accrual basis, adjustments must be made in computing gross receipts and deductions to account for accrued income and accrued expenses.
- (3) Under the accrual basis, credit sales are included in income when the sales are made, not when the money is collected; purchases and expenditures are deducted when the liability is incurred rather than when the account is actually paid.
- (4) These accounting adjustments are made by adding or deducting the increase or decrease in receivables and payables. Rather than compute the increase or decrease in the account receivables during a year, simply add the ending accounts receivable figure and deduct the beginning accounts receivable figure in computing gross income. The beginning accounts receivable figure is subtracted from the bank deposits computation of income because the accounts were collected and the proceeds deposited during the year. The ending accounts receivable figure is then added to the bank deposits computation because the funds are taxable and have not been accounted for in the subject's deposits, expenditures, or cash hoard.
- (5) The same rationale applies to beginning accounts payable which were deducted in the prior year and ending accounts payable that need to be deducted in the taxable year in which they are accrued.

9.5.9.7.4
(03-12-2012)

**Complete Bank Deposits
Method of Proof
Formula**

- (1) The full bank deposits method of proof formula is followed by sections that explain each formula heading and subheading:

BANK DEPOSIT METHOD OF PROVING INCOME**TOTAL DEPOSITS**

Bank accounts: (Business/Personal/Nominee),
Checking accounts,
Savings accounts,
IRA and Keogh accounts,
Credit union,
Investment trusts,
Other accumulation accounts,
Brokerage accounts,
Certificates of deposits.

ADD: INCREASE IN CASH ON HAND**ADD: NON-NEGOTIATED INSTRUMENTS PURCHASED OR
RECEIVED DURING YEAR AND HELD AT YEAR END**

Cashier's checks,
Money orders,
Customer's checks,
US savings bonds.

ADD: OTHER

Amounts automatically withheld from wages,
Withheld taxes, health/life insurance premiums,
Retirement funds, savings, other payroll deductions.

ADD: CURRENCY EXPENDITURES

Business,
Personal (including cash gifts),
Capital (investment).

ADD: NON-CASH INCOME

Payments in kind,
Forgiveness of debt in lieu of payment,
Property in lieu of payment,
Constructive dividends,
Ending accounts receivable (if on accrual basis).

SUBTOTAL (TOTAL FUNDS AVAILABLE)

BANK DEPOSIT METHOD OF PROVING INCOME**LESS: NON-INCOME DEPOSITS AND ITEMS**

Currency withdrawals,
Transfers between accounts and re-deposited items,
Checks to cash (and cashed third-party checks),
Loans, gifts, inheritances received,
Beginning accounts receivable (if on an accrual basis),
Decrease in cash-on-hand,
Exclusions under IRC,
Return of capital (Basis of stock and capital items),
Capital losses — carry forwards,
Bank errors and missing checks,
Returned customer checks,
Federal tax refunds and insurance proceeds,
Savings accounts withdrawals,
IRA and Keogh payments,
Life insurance proceeds,
US savings bonds redeemed,
Social security payments received,
Veterans benefits received,
Nontaxable portion of pensions and annuities,
Cost basis of property sold,
Child support payments received,
Travel expense reimbursement,
Repayments of loans made by others.

ADD: CAPITAL LOSSES EXCEEDING \$3,000**EQUALS: SUBTOTAL GROSS INCOME (if there is no cost of goods sold)****LESS: COST OF GOODS SOLD**

Beginning inventory,
Add: purchases,
Less: ending inventory,
Equals: cost of goods sold.

EQUALS: GROSS INCOME

(if cost of goods sold is involved)

LESS: TOTAL BUSINESS EXPENSES

Add: business expenses per bank records,
Add: additional expenses identified,
Add: depreciation,
Add: ending accounts payable re: business expenses (if accrual basis),
Less: fraudulent expenses identified,
Less: beginning accounts payable re: business expenses (if accrual basis),
Equals: total business expenses.

EQUALS: TOTAL INCOME

BANK DEPOSIT METHOD OF PROVING INCOME**LESS: ADJUSTMENTS TO INCOME**

IRA deduction,
Spouse IRA deduction,
Moving expenses,
One half self employment tax,
Self employed health insurance deduction,
Keogh retirement plan and SEP deduction,
Penalty on early withdrawal of savings,
Alimony paid,
Total adjustments to income.

EQUALS: CORRECTED ADJUSTED GROSS INCOME**LESS: ITEMIZED DEDUCTIONS/STANDARD DEDUCTIONS (AS CORRECTED) AND PERSONAL EXEMPTIONS (AS CORRECTED)****EQUALS: CORRECTED TAXABLE INCOME****LESS: REPORTED TAXABLE INCOME****EQUALS: ADDITIONAL TAXABLE INCOME FOR CRIMINAL PURPOSES**

9.5.9.7.4.1
(11-05-2004)
Total Deposits

- (1) In the analysis of bank deposits, the sums deposited (or credited) to all of the subject's various accounts are totaled to determine gross deposits. This includes any interest and dividends credited to the subject during the investigation period. When the subject holds bank accounts in fictitious names, or with special titles such as trustee account or trading account, deposits to those accounts must also be included in the subject's total deposits. The analysis of bank deposits is not limited to bank checking and savings accounts, but includes deposits to:
 - a. Savings and loan accounts,
 - b. Credit union accounts,
 - c. Brokerage accounts (all credits to accounts),
 - d. Investment trusts,
 - e. Individual retirement accounts and Keogh plan accounts,
 - f. Certificates of deposits.
- (2) If the subject itemized checks on a deposit slip and then deducted an amount for "less cash," only the net amount deposited should be considered in computing income.

9.5.9.7.4.1.1
(11-05-2004)
Unidentified Deposits

- (1) The source of individual deposits can often be identified by the subject's admissions, deposit slips, bank ledger sheets, transfer letters, bank microfilm, and the testimony of witnesses.
- (2) In the event there are unidentified bank deposits, the following elements are required before treating unidentified bank deposits as current taxable receipts:
 - a. Evidence showing the existence of an income-producing business or activity,

- b. Regular or periodic deposits having the inherent appearance of current receipts; occasional or irregular deposits may also be considered as current income if evidence supports this assumption.

- (3) In the *Gleckman* investigation, deposits were principally derived from unidentified sources and the investigation was successfully prosecuted. It is far easier to present a bank deposits investigation to a jury when many of the deposits have been specifically identified as current taxable income. For example, when multiple specific omitted sales are traced to the subject's bank accounts, but other deposits of a similar nature remain unidentified, the government's investigation is strengthened immeasurably. Through the specific identification of multiple omitted deposits, the special agent's assertion that unidentified deposits of a similar nature are current taxable income becomes more credible.

9.5.9.7.4.1.2
(11-05-2004)

Currency Deposits

- (1) Currency deposits are subject to claims that the source of the deposits came from a cash hoard. If the subject raises this claim and it cannot be refuted, the amount of cash deposits in question must be included under "Non-income Deposits and Items" and subtracted from the bank deposits computation.
- (2) However, this type of claim can often be refuted. By firmly establishing the beginning cash on hand, a special agent can rule out the cash hoard defense.
- (3) The computation of gross receipts is based upon the assumption that most deposits are derived from a taxable source. The subject should be interviewed to determine whether or not there were any deposits made into the accounts from non-taxable sources. The special agent should follow-up on any lead offered by the subject or uncovered during the course of the investigation that indicates certain deposits were from a non-taxable source.

9.5.9.7.4.1.3
(11-05-2004)

Starting Point

- (1) In a bank deposits investigation, the starting point refers to the cash on hand at the beginning of the first year under investigation.
- (2) Establishing a firm starting point is necessary in all bank deposits investigations involving cash deposits, currency expenditures, and increases or decreases in cash on hand. The special agent has the same obligation to firmly establish beginning cash on hand while employing the bank deposits method of proof as in the net worth method of proof. He/she is required to show that the income being charged to the subject is current taxable income and not funds accumulated in prior years in the form of a cash hoard. Additionally, establishing a firm ending cash on hand will enable the special agent to determine whether there has been an application of cash (in the investigation of an increase in cash on hand) and/or whether the subject has a source of non-taxable funds (in the investigation of a decrease in cash on hand). (See IRM 9.5.9.5.5, Establishing the Starting Point.)

9.5.9.7.4.1.4
(11-05-2004)

Brokerage and Security Accounts

- (1) Deposits (credits) to a brokerage account are not treated any differently than any other type of deposits. However, when analyzing security account deposits, it is necessary to be familiar with what documents are available and with the terms associated with these statements. These include:
 - a. **Confirmation slips** — issued by brokerage houses to verify purchases and/or sale of stocks.

- b. **Margin account**— a type of brokerage account through which the account holder is extended credit. Stocks can be purchased at a given percentage of their actual cost, the balance being owed to the brokerage firm. The account holder maintains a debit balance in this account.
 - c. **Cash account** — within a certain number of days (usually 3 banking days) after purchasing stocks, the account holder must remit the entire purchase price to the brokerage firm. No credit or debit balance is maintained.
 - d. **Street holdings** — an account holder can purchase stocks through his/her brokerage firm and leave those stocks in the account. These shares are held by the brokerage firm on behalf of the account holder. The actual certificates being in the name of the brokerage firm. These stocks appear on the brokerage statements as security holdings or are noted as securities positions (PSN).
 - e. **Personal holdings** — after purchasing stocks through a brokerage firm, an individual may have those stocks delivered to him/her to become personal holdings. Certificates in the person's name are issued and sent to him/her along with a cover letter or securities delivered slip. Those shares will no longer appear on the brokerage statements as securities positions. Personal holdings of an individual must be traced through the appropriate stock transfer agent. Use the Moody's Handbook of Common Stocks as a reference to determine the stock transfer agent for a particular stock.
 - f. **Securities delivered** — noted as SEC DEL, indicates when the stocks were delivered or sent to the account holder to become personal holdings.
 - g. **Securities received** — noted as SEC REC, indicates when the account holder send funds to the brokerage firm to cover the purchase of stocks or a debit balance. It does not necessarily mean currency.
 - h. **Cash disbursed** — noted as CSH DSB, indicates when the brokerage firm issues a check to the account holder.
- (2) One important difference between many brokerage statements and bank statements is that, when a stock is sold, the amount of the sale appears as a credit to the account on the date of the sale. If the account holder requests a portion of the proceeds of the sale to be paid to him/her by check, those proceeds are then shown as cash disbursed/check for that same date. The net deposit amount does not appear on the statement. When analyzing brokerage statements, the special agent must manually make the computation to net the deposit. Only the net amount should be picked up as a deposit.

9.5.9.7.4.2
(11-05-2004)

Cash on Hand Increase

- (1) An increase in the subject's cash on hand is treated as a currency expenditure. Since the subject may contend that the unexplained deposits into the bank accounts came from a cash hoard, it is crucial to thoroughly establish and document any increase in the subject's cash on hand.
- (2) The special agent must begin by documenting the cash on hand at the starting point and then document cash on hand at the end of each year under investigation. The cash on hand increase (or decrease) is then determined for the first year of the investigation by subtracting the cash on hand at the starting point from the cash on hand at the end of the first investigative year. (Cash on hand decreases will be discussed later.)

- (3) It is important to interview the subject early in the investigation to accurately identify a maximum cash accumulation for each year under investigation. (See IRM 9.5.9.5.5.(11).)
- (4) All of this information is necessary to establish the consistency and reliability of the subject's statements. Usually, no direct evidence of cash on hand is available. Statements made about the source, amount, and use of funds can be corroborated or refuted with additional evidence.

9.5.9.7.4.3
(11-05-2004)

**Non-Negotiated
Instruments Purchased
During the Year and
Held at Year-End**

- (1) Non-negotiated instruments purchased or received during the year and held at the end of the year must be properly accounted for in the bank deposits formula. Non-negotiated instruments include:
 - a. Cashier's checks,
 - b. Money orders,
 - c. US savings bonds,
 - d. Travelers checks,
 - e. Non-negotiated income checks.
- (2) When non-negotiated instruments are purchased by check, total deposits are increased by the amount of the non-negotiated instruments. Non-income items are increased by a like amount. This is similar to a transfer as money deposited in the bank is being converted to a non-negotiated instrument.
- (3) If the subject receives a monetary instrument as a gift and has not negotiated it at year-end, total deposits and non-income items are each increased by the amount of the instrument.
- (4) Total deposits are not increased to reflect the value of non-negotiated instruments purchased in currency. This amount is included as a currency expenditure in the bank deposits formula.
- (5) Technically, if a cash basis subject received checks as income and had not negotiated them at year-end, they must be added to total deposits to accurately calculate income. The checks are income in the year they are received. However, if this is the subject's normal business procedure, then the relevance of this "timing" issue should be discussed with the Criminal Tax (CT) Counsel.

9.5.9.7.4.4
(11-05-2004)

**Amounts Automatically
Withheld from Wages**

- (1) Amounts that are automatically withheld from the subject's wages must be included when using the bank deposits method, unless they are included in deposits to another account. These items include withheld taxes, health and life insurance premiums, retirement fund contributions, savings account allotments, Federal Insurance Contributions Act (FICA), child support and or alimony payments, loan payments, and any other payroll deductions made by the employer for the benefit of the employee. The special agent should include only those items that are not included elsewhere in the computation. An example of an item that may appear elsewhere in the computation would be automatically withheld savings account allotments. These allotments would be picked up with the total deposits to the savings account.

9.5.9.7.4.5
(11-05-2004)

Currency Expenditures

- (1) All documented cash expenditures, regardless of the source of the currency, are added to total deposits. Even in the most thorough investigations, there are certain currency expenditures that are impossible to document. These expenditures, i.e., groceries, laundry, meals, gasoline, etc., cannot be added to total deposits unless they are fully documented. Only those currency expenditures which are documented, either directly or indirectly, can be included in the bank deposit computation.
- (2) If the subject claimed business expenses on his/her return in excess of the amount of business expenses he/she paid by check, the balance should be treated as a cash expenditure and included in the bank deposits computation.
- (3) If the subject alleges additional currency business expenses not claimed on the return, these should be allowed, after adding a like amount to the cash expenditures figure in the computation.
- (4) Any documented expenditure made by the subject (business or personal) should be analyzed to determine what portion of that expenditure was made by check. If the amount of the expenditure exceeds payments made by check, the balance should be considered a cash expenditure and included in the bank deposits computation.

9.5.9.7.4.6
(11-05-2004)

Non-Cash Income Items

- (1) In addition to currency expenditures, all non-cash items should be added to deposits. These items include:
 - a. Payments in kind,
 - b. Forgiveness of debts in lieu of payments,
 - c. Property received in lieu of payments,
 - d. Constructive dividends,
 - e. Accounts receivable increase, if the subject is on the accrual basis.

9.5.9.7.4.7
(11-05-2004)

Non-Income Deposits and Items

- (1) All potential nontaxable sources of funds should be discussed with the subject during the initial interview. If the subject refuses to communicate with the special agent outside the presence of an attorney, consider contacting the subject's attorney. Explain to the attorney that if their client has received funds from nontaxable sources that could explain the apparent understatement of income, it would be to the subject's advantage to come forward with this information.
- (2) It is the government's responsibility to elicit all available information concerning the subject's claims as to his/her nontaxable sources of funds. The special agent should attempt to obtain this information early in the investigation. The sooner the subject's claims can be verified or refuted, the sooner the special agent can determine whether or not there is a viable investigation.
- (3) All potential nontaxable sources of funds should be thoroughly investigated by questioning the subject's spouse, relatives, friends, and associates.
- (4) The special agent should examine all available documents, i.e., (banking records, public records etc.) and follow-up leads that could identify potential nontaxable sources of income and/or commingled funds.
- (5) The special agent should determine the source or disposition of funds related to the acquisition and/or sale of assets.

- (6) Nontaxable items will often appear as large or unusual deposits in the bank accounts.
- (7) All funds from nontaxable sources must be accounted for when using the bank deposits method of proof to calculate the subject's potential understatement of income.
- (8) Deducting nontaxable funds ensures that all deposits, cash expenditures, and increases in cash on hand which are included in the subject's gross income are derived from taxable sources. Failure to eliminate all known non-income deposits and items results in an overstatement of income and could prove fatal to the criminal investigation. Examples of non-income deposits and items include:
 - a. Income earned in prior years,
 - b. Cash on hand decrease,
 - c. Loan proceeds received,
 - d. Repayments of loans made to others,
 - e. Gifts,
 - f. Inheritances,
 - g. Re-deposited items,
 - h. Transfers between accounts,
 - i. Return of capital,
 - j. Cashed third party checks,
 - k. Checks to cash and currency withdrawals,
 - l. Other non-income deposits and items specifically excluded by the USC,
 - m. Life insurance proceeds,
 - n. Tax-exempt interest,
 - o. Federal income tax refunds,
 - p. US savings bonds redeemed (cost basis),
 - q. Social Security payments,
 - r. Veterans' benefits,
 - s. Nontaxable portion of pensions and annuities,
 - t. Payments made to individual retirement accounts.

9.5.9.7.4.7.1
(11-05-2004)
**Checks to Cash and
Currency Withdrawals**

- (1) Currency withdrawals from accounts and checks payable to cash are generally treated as non-income items and must be discarded when computing gross income. Unless there is strong evidence to the contrary, the government usually cannot disprove the defense that the currency was:
 - a. Re-deposited by the subject later in the tax period,
 - b. Used as a source of currency expenditures already included in the bank deposits computation,
 - c. Used for a business expense paid in currency not previously claimed,
 - d. Used to increase cash on hand.

9.5.9.7.4.7.2
(11-05-2004)
**Automated Teller
Machines and Debit
Card Transactions**

- (1) Automated Teller Machines (ATM) withdrawals are considered to be currency withdrawals. However, when an ATM card is used as a debit card to pay a merchant, the amount debited and paid to that merchant is not considered a currency withdrawal. (This is really an electronic check.)

9.5.9.7.4.8
(11-05-2004)

Cash on Hand Decrease

- (1) Cash on hand is one of the most common and troublesome areas in any indirect method computation. Because a cash hoard defense is so difficult to refute, subjects frequently claim their cash hoard was of a sufficient amount to account for any understatement of income. The special agent must anticipate this potential defense and be able to prove that the subject had a large sum of cash which is not represented in the bank deposit computation.
- (2) Evidence that may negate the existence of a cash hoard includes:
 - a. Written or oral admissions of the subject to the special agent(s) which indicate a small amount of cash on hand,
 - b. Financial statements prepared by the subject showing a low net worth,
 - c. Compromises of overdue debts by the subject,
 - d. Foreclosure proceedings against the subject,
 - e. Collection actions against the subject,
 - f. Tax return (or no returns filed) indicating little or no income in prior years,
 - g. Loan records,
 - h. Consistent use of checking and savings accounts,
 - i. Recurring overdraft on NSF charges or other bank penalties,
 - j. Minimum payments on credit card balance.
- (3) It may be possible to reconstruct the subject's cash on hand from prior earnings records. If cash on hand for an earlier period can be reasonably established, income earned from that period forward to the starting point could be used to establish a maximum available cash on hand. (See IRM 9.5.9.5.5.1, An Indirect Approach for Establishing a Starting Point.)
- (4) If an investigation discloses an increase or decrease in cash on hand during the prosecution period, an adjustment to the bank deposits formula must be made. If there is an increase to cash on hand, it is added to deposits and currency expenditures in the bank deposits computation; at the same time, any decrease in cash on hand is considered a non-income item.

9.5.9.7.4.9
(11-05-2004)

Loan Proceeds

- (1) Loan proceeds received by the subject must be accounted for as a non-income item. The key word in the above sentence is "received." The subject must have physically received the funds.
- (2) If a subject has a mortgage on his/her home, the mortgage was paid directly by the lender to the seller of the home. Since no funds passed through the subject's hands, there is no need to account for any loan proceeds in this transaction.
- (3) However, if the subject had obtained a loan from a lender and actually received the loan amount in cash, a check that was subsequently cashed, or by way of a transfer of funds to the subject's account, the loan proceeds must be accounted for as a non-income item.

9.5.9.7.4.10
(11-05-2004)

Loan Repayments Received

- (1) If the subject made a loan in prior years and contends that part of the understatement of income is in fact a repayment of that loan, the special agent must document the repayment of principal by contacting the borrower. All repayments of principal loaned by the subject should be treated as a non-income item.

9.5.9.7.4.11
(11-05-2004)

Gifts and Inheritances

- (1) Monetary gifts, cash, checks, etc. must also be included as a non-income item in the bank deposits formula.
- (2) The special agent should document the gift and determine whether the donor was financially able to make the gift. Obtain all of the necessary documents and other information from the donor. Check for filed gift tax returns, if applicable.
- (3) If the subject received an inheritance, obtain all necessary documents and information from the executor or administrator of the estate to verify the inheritance. Check for filed estate tax returns and check the probate records of deceased relative's estate. Any such inheritance is also treated as a non-income item.

9.5.9.7.4.12
(11-05-2004)

Transfers Between Accounts

- (1) Transfers between accounts should be classified as non-income items.
- (2) A subject who maintains several accounts, or one who has opened and closed accounts during the years under investigation, generally will have transfers between accounts. A detailed examination of deposit slips and account statements should be made to determine all possible transfers between accounts.

9.5.9.7.4.13
(11-05-2004)

Return of Capital

- (1) Generally, any return of capital is classified as a non-income item in the bank deposits method. However, the treatment of assets sold in a bank deposits investigation differs depending on the nature of the asset, i.e., whether it was a personal asset, a business asset, or stock.
- (2) When the subject sells a personal asset there is no allowable loss relative to the transaction. Instead, such transactions are treated as a return of capital which is limited to the cost basis or adjusted basis of the asset, if there is a gain, or the sale price if there is a loss. The following example is an illustration:

If the subject purchased a vehicle in 1995 for \$20,000 and sells it in 1996 for \$15,000, the special agent would treat the \$15,000 as a return of capital in the bank deposits formula for 1996. If the subject managed to sell the same vehicle for \$30,000, the special agent would allow the subject a \$20,000 return of capital reduction to the bank deposits computation.

- (3) The above stated tax treatment applies only to personal assets that are sold. Using the same example above, if the subject traded in the 1995 vehicle on a 1999 model that cost \$30,000, there is no return of capital. The subject did not physically receive the money. The return of capital was rolled into the new vehicle.
- (4) The sale of a business asset or of stock is treated somewhat differently because it can result in an allowable taxable loss. The proper way to treat these assets is to use the cost (or adjusted basis) as the return of capital.
- (5) When stocks and/or other business assets are sold, and the sale results in a net capital loss, that loss must be limited to \$3,000 in accordance with USC loss limitations. This is done by adding back any disallowed loss to the bank deposits formula. See ADD: Capital losses exceeding \$3,000 in the formula. (See IRM 9.5.9.7.4, Complete Bank Deposits Method of Proof Formula.)

- (6) In order to compute the return of capital on a stock transaction, the special agent must first determine the subject's basis in the stock. If the stock sale (gain or loss) was reported on the subject's return, use the method the subject elected on their return when computing the gain or loss for the stock transaction.
- (7) If stock sales are not reported on the return, and stock sales have been made during the period under investigation, the special agent should analyze any available evidence and determine if it is possible to identify the shares that were sold. If the subject only bought the stock on one occasion, then multiply the number of shares purchased by the purchase price and add in the sales commission. The total is divided by the number shares purchased to arrive at the basis per share. This figure is then multiplied by the number of shares sold to arrive at the basis for the shares sold. This figure is then subtracted from the sales price realized, not including the sales commission, and the resulting figure is the subject's gain or loss on the sale.
- (8) An attempt to identify the shares sold can also be made by contacting the brokerage firm and comparing the date on the stock certificates being held with the information available on the statements. An example of this would be if the subject purchased 200 shares of SAYS stock in January 1996 with a basis of \$10 per share. Then, in February 1996, the subject purchases 50 more shares of stock with the basis of \$5 per share. In March 1996, the subject sells 100 shares of stock. It cannot automatically be assumed the 100 shares sold were the initial 100 shares purchased. However, if the brokerage firm is contacted and they are holding only the certificate for the 50 shares purchased in February 1996, then it can be concluded that the subject did indeed sell the initial 100 shares purchased.
- (9) If the brokerage firm is not holding the stock certificates, and the special agent cannot determine from the available records which shares were sold, the special agent must resort to computing the gain or loss using the method which is most advantageous to the subject. This involves computing the basis of the stock using the Last-in, First-out (LIFO), First-in, First-out (FIFO), and Average methods. The sales commission should be included when computing the basis of the stock purchased. However, when stock is sold, the commission is not included in the computation. This computation is only made when the basis of the stock cannot determine the basis from available records.

9.5.9.7.4.14
(11-05-2004)
Cost of Goods Sold

- (1) When dealing with a subject who reports business activity through a Schedule C, it may be necessary to include a cost of goods sold computation when utilizing the bank deposits method.
- (2) A reduction in inventory is a situation where there is a deduction and no cash outlay. Whenever inventories are a factor in determining income, it is necessary to make an adjustment for changes in inventory, unless the subject ignored them on the return. This requires that the special agent compute the cost of goods sold. This is done by adding purchases to the beginning inventory and subtracting the ending inventory. The cost of goods sold is then included in the computation of gross income. These steps are illustrated in the bank deposits formula.

9.5.9.7.4.15
(11-05-2004)

Business Expenses

- (1) All business expenses and costs must be allowed to the subject whether paid by check or in cash. If the analysis of checks or other evidence leaves doubt about the disbursements, it is preferable to allow all items, except those which are undeniably nondeductible, i.e., items such as personal expenses, investments, and gifts. When canceled checks are not available for analysis and classification, every effort should be made to identify any and all items which constitute allowable expenses whether paid out of a bank account or from undeposited cash.
- (2) Often, the total business expenses on a Form 1040, Schedule C will exceed the expenses for which checks or specific evidence of cash disbursements are found. In these instances, the amounts claimed by the subject should be allowed by assuming the difference was paid in cash. Increasing currency expenditures in the bank deposits formula offsets the effect of allowing business expenses paid in cash as a deduction.
- (3) If personal or capital expenditures are improperly classified as business expenses, the deduction for business expenses will be overstated, gross receipts will be unaffected, and net taxable income will be understated. Without proof that personal or capital items were claimed fraudulently as business expenses, they cannot be disallowed.
- (4) The allowable depreciation on all known depreciable assets must also be deducted. Depreciation is treated separately, since this is a deduction from which no cash outlay is required in the year the deduction is taken.

9.5.9.7.4.16
(11-05-2004)

Adjustments to Income

- (1) All the available adjustments to income must be allowed in computing adjusted gross income. This would include applicable Individual Retirement Plan (IRA), Keogh and Simplified Employee Pension Plan (SEPP) deductions, moving expenses, one half of the self employment tax deduction, the self employed health insurance deduction, penalty on early withdrawal of savings, and alimony paid.

9.5.9.7.4.17
(11-05-2004)

Personal Deductions and Exemptions

- (1) All allowable personal deductions, itemized or standard, and exemptions must be deducted from adjusted gross income to arrive at taxable income.
- (2) Per statute, itemized deductions and personal exemptions may be subject to limitation or phase out depending on the subject's income. The special agent should make adjustments to these amounts as necessary.

9.5.9.7.4.18
(11-05-2004)

Technical Adjustments

- (1) In a criminal investigation, reported taxable income can be increased only by the amount of the criminal adjustments. If an error was made in the preparation of a subject's return and income is understated, the amount must be included as a non-income item in arriving at taxable income for criminal purposes.
- (2) If the subject unintentionally overstated expenses, no adjustment is necessary. The subject would be allowed the expenses per the return. Each non-fraud item must be separately allowed as claimed on the return or as corrected whichever is to the best interest of the subject. Technical adjustments in favor of the government cannot be made, offset, or netted against technical adjustments in favor of the subject.

- 9.5.9.7.5
(09-03-2020)
Schedules and Summaries in Bank Deposits Investigation
- (1) Schedules and summaries are illustrative of those which may be submitted during trials when the bank deposits method of proof is used.
 - (2) An analysis of deposits is the vital part of a bank deposits investigation and too much importance cannot be placed upon its accuracy.
- 9.5.9.7.6
(11-05-2004)
Defenses in Bank Deposits Investigation
- (1) The chief defense contentions in bank deposits investigations (other than lack of criminal intent) are:
 - a. That the sporadic nature or unconventional amounts of the deposits indicate that prior accumulated funds, not current receipts, or non-taxable funds are involved,
 - b. That the deposits reflect, in whole or in substantial part, non-income items or income items attributable to other years,
 - c. That the deposits are a duplication of current year income items already accounted for by the subject.
 - (2) The proof concerning what cash a subject had on hand at the beginning of the taxable year in question is relevant to the bank deposits method of proof.
 - (3) If the deposits or expenditures are from funds accumulated in prior years, they do not represent current income.
 - (4) The lack of proof of the amount of cash on hand would not preclude prosecution if all the requirements are met set forth in IRM 9.5.9.7.4.8, Cash on Hand Decrease.
- 9.5.9.8
(11-05-2004)
Cash Method of Proving Income
- (1) The cash method of proof is an indirect method of proof of undeclared income which focuses on expenditures made in currency. The cash method is simply a variant of the expenditure method of proof. The cash method is based on the same kind of investigation and analysis performed in the expenditures method, however, it represents a different presentation of the results of the investigation.
 - (2) The cash method of proof seeks to identify unreported cash income.
 - (3) The cash method of proof examines the extent to which a subject's cash expenditures exceed his/her known cash sources. To the extent the subject uses more cash than that which can be traced to his/her non-taxable and declared cash sources, the surplus cash must be taxable unreported income.
- 9.5.9.8.1
(11-05-2004)
Authority for Using the Cash Method
- (1) Like the net worth and expenditures methods, there is no statutory provision defining the cash method of proof and expressly authorizing its use by the Commissioner. The courts have approved the use of this method in *United States v. Hogan*, 886 F. 2d 1497 (7th Cir. 1989).
- 9.5.9.8.2
(11-05-2004)
When and How the Cash Method is Used
- (1) Special agents should resort to the cash method of proof when a subject's unreported income comes entirely in the form of cash. The cash method is most appropriate in investigations involving bribery, drug dealing, cash skimming from businesses, and similar situations where unreported income is in the form of cash.

Note: The cash method of proof is not as well recognized and widely used as the other indirect methods of proof. Accordingly, it should only be used when the other methods of proof are not available.

- (2) The cash method is effective when the subject has limited sources of income and deposits the income from these sources in a bank account where non-cash uses can be traced.
- (3) Sources of cash include cash returned on deposits, checks written to cash, cash withdrawn from financial accounts, cash contents of a safe deposit box, and cash on hand.
- (4) The special agent must establish the following in support of the cash method of proof:
 - Subject’s opening net worth and cash on hand.
 - Subject’s expenditures during the period(s) under investigation.
 - The likely source of the unreported income.
 - All potentially nontaxable sources of income. To negate nontaxable sources of income, the special agent must investigate all reasonable leads.

9.5.9.8.3
(11-05-2004)
**Comparison of the Cash
Method and Expenditure
Method**

- (1) The following similarities exist between the cash and expenditures methods:
 - The methods are used in investigations in which a subject consumes his/her income rather than using the income to increase year end assets.
 - The methods require that there is a sufficiently defined starting point to determine the extent to which pre-existing cash or conversion of assets provided a source of cash to be expended in the tax years examined to account for non-taxable sources of income.
 - The methods examine the extent to which expenditures in a tax year exceed non-taxable sources of income and taxable sources of income which the subject has reported.
- (2) The following differences exist between the cash and expenditures methods:
 - The cash method focuses only on cash uses and cash sources, and is designed to identify unreported income in the form of cash.
 - The subject’s opening and closing net worth do not need to be established except when the net worth contains assets that are converted into sources for cash during the year(s) under investigation.

9.5.9.8.4
(11-05-2004)
**The Cash Method of
Proof Formula**

- (1) The cash method of proof formula is as follows:

	All Cash Uses
Less	Known Cash Sources
Equals	Additional Taxable Income (Unre- ported Income)
- (2) Known cash sources includes cash income reported and any non-taxable sources.

9.5.9.9
(11-05-2004)
**Percentage Markup
Method of Proving
Income**

- (1) This method is a computation whereby determinations are made pursuant to the use of percentages or ratios considered typical of the industry or business under investigation. By reference to similar businesses or situations, percentage computations are secured to determine sales, cost of sales, gross profit, and net profit. Likewise, via the use of some known base and the typical percentage applicable, individual items of income or expense may be determined.
- (2) The percentage markup method is used on a limited basis.

9.5.9.9.1
(11-05-2004)
**Use of Percentage
Markup Method**

- (1) Special agents should resort to the percentage markup method of proof only when other traditional methods of proof have proven unsuccessful.
- (2) With respect to specific applications of the percentage markup method of proof, its use should be limited principally to retail establishments, rather than illegal businesses, because more reliable information regarding opening and closing inventories, and the appropriate percentage markup, is generally available for retail establishments.
- (3) An exception to these preferences may be narcotics trafficking investigations so long as substantial inside evidence from members of the narcotics organization is available to account for the pertinent variables inherent in narcotics trafficking and this method of proof.
- (4) Special agents should include an explanation of efforts made with respect to the utilization of the traditional methods of proof and an explanation for the inadequacy or inapplicability of those methods.

9.5.9.9.2
(11-05-2004)
**Application of
Percentage Markup
Method**

- (1) The percentages used in the percentage markup method may be externally derived or may be internally derived from the subject's accounts for other periods or from an analysis of subsidiary records.
- (2) Percentages may be secured from the examination of the subject's records even though such records are only partially available.
- (3) Gross profit percentages may be determined by comparing purchase invoices with sales invoices, price lists, and other similar data.
- (4) Other years not covered by the investigation, or portions of years under investigation, may indicate typical percentages applicable to the entire year or years under investigation.
- (5) Substantial internal evidence from which a reliable percentage markup computation can be obtained is strongly emphasized. Testimony of employees, accountants, or sales managers with direct knowledge of sales prices is important in determining not only the actual percentage markup employed in a given investigation, but also opening and closing inventories.
- (6) Consideration should be given to obtaining internal documents, such as operating memoranda and subsidiary books and records.
- (7) The questionable tax returns and the amounts stated therein for sales and costs of goods sold should not be used in determining the appropriate percentage markup. Use of such returns contradicts the theory that both sales and cost of goods sold are fraudulently reported on the tax returns.

9.5.9.9.3
(11-05-2004)

**Limitations on
Percentage Method**

- (1) Although the percentage method may be useful in determining or verifying income, especially when the books and records are inadequate, special agents must ensure that the comparisons are made with situations that are similar to those under investigation. Some of the factors to be considered are as follows:
 - a. *Type of merchandise handled*—In order for a proper comparison to be made, the businesses must be dealing in the same type of merchandise or service. Comparison of the gross profit of a restaurant with that of a grocery store would be of little value and should not be used.
 - b. *Size of operation*—In many instances, gross profit, cost of goods sold, and net profit percentage on sales will vary according to the size of a business. This is especially true with respect to expense items and the net profit compared with sales. The percentage of net profit to sales of a large department store might vary considerably from that of a small independently-owned general store.
 - c. *Locality*—Markups and costs of operations will normally vary with the size of the city or the location of the businesses in the city. As an example, a small business in a community of 5,000 may use newspapers as a means of advertising, whereas a business doing the same volume in a city of 500,000 will normally find the cost prohibitive and confine advertising to some other medium.
 - d. *Period covered*—Since gross profit ratios and expense ratios will tend to vary year to year with economic conditions, the comparison should normally be made with similar periods covered by the investigation.
 - e. *General merchandising policy*—Comparison should not be made between businesses having different merchandising policies. Some businesses may operate on a large volume with a small markup and little customer service, while other businesses have the opposite merchandising policy. In situations of this kind, comparisons should be made only with those businesses having similar merchandising policies.

9.5.9.9.4
(09-03-2020)

**Examples of Percentage
Method**

- (1) The percentages used are arbitrary and are not necessarily applicable to the businesses mentioned.

9.5.9.10
(11-05-2004)

**Unit and Volume
Methods**

- (1) In many instances the determination or verification of gross receipts may be computed by applying price and profit figures to the known or ascertainable quantity of business done by the subject. This method is feasible when special agents can determine the number of units handled by the subject and also when the price or profit charged per unit is known.
- (2) The number of units sold or quantity of business done by the subject may be determined in certain instances from the subject's books, since the records may be adequate with respect to cost of goods sold or expenses, but inadequate as to sales.
- (3) There may be a regulatory body to which the subject reports units of production or service. For example:
 - a. A funeral director is required to report each burial to the city or town where the burial takes place.
 - b. A garment manufacturer with union employees buys union labels to be sewed into the garments it manufactures.

- c. A subject may be required to report production and payroll to a trade association allied with the labor union.
 - d. There are instances where the fees paid for leased machinery is based upon the units of production.
 - e. A piecework system of wages for production workers might give an accurate measure of units produced.
- (4) The use of this method lends itself to those businesses in which only a few types of items are handled, or there is little variation in the type of service performed, since the charges made by the subject for the merchandise or services are relatively the same throughout the taxable period.
- (5) The following example is illustrative of the unit and volume method of computation:

Volume of Merchandise (Manufacturer):

Number of machines manufactured	92
Average sales price	\$1,100
Computed total sales	\$101,200
Sales reported	\$93,500
Omitted sales	\$7,700

