Cash Intensive Businesses Audit Techniques Guide - Chapter 2: Pre-Audit and Background Review of the Tax Return

Contents

Pre-Contact Analysis of the Tax Return

Regardless of what techniques the examiner employs to examine a return, a thorough pre-audit analysis is essential to discover potential audit adjustments and fraudulent situations. The beginning of any examination is a pre-contact analysis, which is a review of the tax return to identify potential issues and data needed to plan the examination. The analysis should cover all aspects of the return.

Some items on a Form 1040, which are important in a pre-contact analysis, are listed below. (Note: There are many more items, but these are only a suggestion to get you started.)

1. Page one and two of Form 1040: Filing status, family size, address, wage income, interest income, business income, capital gain or losses, rental or farm income, miscellaneous income, credits claimed, other taxes paid, and taxpayer's occupation.

   a. Is the taxpayer's address in a high value area, disproportionate to reported income?
   b. Is the occupation a position that could have indirect sources of additional income?
   c. Will reported income support the size of family reflected?
   d. Is the foreign accounts question answered?

2. Schedule A

   a. Itemized Deductions
      1. Real Estate Tax: Compare with taxpayer's address. Do the taxes suggest that other property is owned by the taxpayer? Does the real estate tax deduction show additional properties not commensurate with reported income?
      2. Interest: Does interest expenses indicate loans or property holdings? Does the interest deduction show indebtedness on purchases not commensurate with reported income?
      3. Miscellaneous Deductions: Any unusual items, such as large gambling losses?
   b. Do total deductions indicate expenditures in excess of net income reported?

3. Schedule B: Interest and Dividend Income. Check amounts for accumulation of funds; number of accounts; or lack of interest or dividends. Are the interest and dividend income and the corresponding investments consistent with reported income?

4. Schedule D: Property sold and property purchased. During the audit, consider, when properties are purchased and sold, note the source of funds used and where the proceeds were reinvested. Review Form 1099 information received.

5. Schedule C or F: Type of business, accounting method, gross profit percentage compared to similar type business, net income, interest expense (does the taxpayer pay cash or finance the purchase of business assets?), Depreciation Schedule (did the taxpayer purchased assets during the year) and any unusual items. Sales Tax: Any capital items purchased? Does the sales tax deduction indicate any purchases not commensurate with reported income?

6. Review the appropriate industry audit technique guide for additional items for now and future consideration such as:

a. Note how gross income may be computed. How can it best be cross-checked to books of original entry?
    1. Reconcile total deposits.
    2. Test-check cash register tapes.
    3. Sample sales slips, job orders, contracts, etc.
    4. Check appointment book, daily log entries.
    5. Estimation of units produced.
b. What are the internal controls on income?
    1. Are all receipts deposited? Are most by currency or check?
    2. Who controls the collection and deposit of receipts?
    3. Who records the receipts into the records?
    4. What other regulatory agencies audit receipts (i.e., sales tax, franchisor)?
    5. Note any sharing by percentage of gross income (i.e., rent, profit sharing).
    6. Does the accountant verify gross income?
    7. How does the owner or stockholder draw living expenses?
    8. Check the controls on employees handling receipts.
    9. Are numbered sales invoices used?
    10. Note the consistency of the accounting method used.
c. What should the business be earning? Consider:
    1. The location (is it accessible to a large market?).
    2. Specialty items (is there a select clientele?).
    3. The number of operating units (cash registers, machines, trucks, chairs, etc.).
    4. The number of employees (and their duties).
    5. Controlled prices on goods sold (as "fair-traded" items).
    6. The age of the business (is goodwill established?).
    7. The gross profit percentage for the industry.
d. Is "other income" possible? For example:
    1. Can the operation produce a saleable by-product? (Scrap, farm products, rebuilt items).
    2. Can the goods or services be traded? (Construction, repairs, personal services, money orders between merchants).
    3. Are there vending or pinball machines?
    4. Check for potential "sub-operations" created by the business (snack bar, repairs, appraisals, installation, and accessories, towing business not listed).
    5. Are there sub-leases or rentals (land, storage spaces, and tools)?
    6. Could kickbacks or rebates be paid or received (construction jobs, coupons)?
e. Other considerations:
    1. Evaluate any other information available (information items, news clippings, etc.).
    2. Unusual situations warranting answers:
        a. High profits, but no savings or investments.
        b. Low profits, but many investments and expenditures.
        c. Increasing assets, but small deductions for interest paid.

d. Decreasing liabilities, and low profits.

Although the above considerations are broad, very little time is used in the above pre-audit analysis. Yet, it is an invaluable tool in planning and executing a quality audit, in minimum time.

From these indicators and the initial Cash-T, examiners should form a financial picture of the taxpayer. One of the key indicators is an accumulation of assets and/or incurring of expenses in excess of available net income and borrowings. When examiners see a return with a large asset accumulation, low net income and small interest expense, examiners need to resolve how this occurred. How could the sole proprietor of a moving business that reports net profits of less than $30,000 each year have purchased four rental properties? Make a note to ask the taxpayer to explain these inconsistencies during the initial interview. Ask the taxpayer to explain the overall situation, if possible, then ask specific questions, such as, How did you purchase property A last year? Where did the down payment money come from?

Examiners must develop an estimated Cash T and/or source and application of funds in the pre-plan stage of the examination to get an idea of the taxpayer's finances. The analysis will be more thoroughly developed as the examination progresses and more information is obtained.

In the case of corporate or partnership returns, your pre-audit analysis should also include:

- Significant changes in balance sheet accounts.
- Unusual entries to the equity balances of the partners.
- Bad debt write-off and recoveries.
- Relationship of funds paid to shareholder(s) or partner (s) versus the individual's standard of living (what does this mean?).
- Disposition of scrap materials (why is this specific to partnerships; it is also mentioned above?).
- Low gross profit ratio in relation to the industry standard.
- Changes and payments between related entities.
- Disproportionately high or low inventory figures.
- Loans receivable and/or loans payable, especially to or from officers or partners.

Review of Internal (IRS) Sources

1. Tax Return (see above for details)
2. Charge-Out Sheet
    - Prior Audit
    - Prior Examiner
3. Examination Specialization &Technical Guidance Program- Audit Techniques Guides
    - For specific methods of developing the scope of your audit based on your taxpayers' industry
4. IRP
5. Accurint - Do the facts match the return?
6. CBRS - Currency & Banking Retrieval System (see below)

    - This is vital with a cash business. A CBRS search will show who handles cash, where transactions are made and the dates and amounts of cash transactions. This information should be obtained during the pre-audit.
7. IDRS (see below)
8. Collection
9. Criminal Investigation Division
10. International
11. MACS - Midwest Region Automated Compliance System
12. TECS - Treasury Enforcement Compliance System (Restricted Use)
13. Research
    - To assist you in understanding your taxpayers' industry.
14. Internal Revenue Manual - Handbooks such as Retail
15. Technical Advisors: (LMSB)
16. Examination Specialization &Technical Guidance facilitators, coordinators and analysts and ES&TG web site.
17. CAS/Engineers/Economists
18. Tax AttachÃ (TA)

Access IDRS or MACS Information

1. Obtain any information on lender/donor/taxpayer/related entities.
    a. IMFOL
    b. BMFOL
    c. IROLE
    d. INOLE
    e. IRP
    f. RTVUE
    g. BRTVU
2. Request MACS returns with proper approvals.

Tax Attaché (TA)

1. TA's can travel to different countries (treaty/non-treaty) to conduct investigations of public records, conduct interviews and work with the local tax authorities.
2. Tax authorities of treaty countries can provide assistance.
    - This is an "unusual" source of information basically used when the taxpayer has issues of foreign accounts, businesses or loans.

Third Party Contacts: Public Records Check

Contacts made with government officials to obtain information that is available to the public are not third party contacts under IRC section 7602(c). Such contacts are routinely made and there is no expectation of privacy with respect to information that is provided to, or maintained by, government officials and is available to the general public. The information must be available to the general public for this contact to be excluded from the IRC section 7602(c) requirements. Some examples are:

- Contacts made with postal officials to obtain a taxpayer’s current address; and
- Contacts made with a county clerk to obtain lien information; and
- Contacts made with a clerk of the court to obtain publicly available court records; and
- Contacts made with state officials to obtain corporate charters or other publicly available information regarding corporate taxpayers or exempt organizations.

The determining factor is that the information must be available to the general public to not be considered a Third Party Contact. Note: In some states, due to rights to privacy (stalking laws) legislation, Motor Vehicle information is not available to the general public and would be considered a reportable third party contact.

Third party return information is defined as information collected about taxpayers, but not the following:

- Information received from the Taxpayer or Representative.
- Information required to be filed with IRS, such as Forms W-2, 1099, etc.
- Information furnished in connection with specific cases being worked by IRS.
- Information received from state agencies in accordance with FedState exchange agreements.

After opening the audit, if observations suggest that the taxpayer may be underreporting income; examiners should consider contacting other third parties either through a summons or letter.

Review of External Sources

Certain conditions will allow the agent to get information from a state or other federal agency without contacting the taxpayer - see 26 U.S.C. 7805 Par. 2. Section 301.7602-2 Third Party Contacts.

- Agencies
    - Bureau of Labor Statistics
    - Social Security Administration
    - U.S. Post Office
    - Department of Motor Vehicles
    - Law Enforcement
    - OSHA - Occupational Safety & Health Administration
    - Department of Social Services
    - Department of Agriculture
    - Small Business Administration
    - Department of Transportation
    - Fictitious Name Register
    - Better Business Bureau

- Court Record
    - Divorce
    - Liens
    - Probate
    - Property records
    - Mortgages (amount/holder)
    - Bankruptcy
- State Information
    - Permits
    - Licenses
    - Sales Tax
    - Employment/Unemployment Data
- Trade Associations
- Corporations (charters, etc.)
- City Directory
- Public Utilities (electric, gas, water)
- Credit applications/reports
- Suppliers
- Employer/Savings & Loan/Credit Unions
- Insurance Providers
- Subscriber Information Sources
    - Dun & Bradstreet
    - Robert Morris & Associates
    - LEXIS
- Former Personal Contacts (landlord, employer, employees, ex-spouse, Neighbors)
- Third party contacts (i.e. Taxpayer's landscaper/lumber yard- can lead to addresses where lumber was delivered)
- Newspaper articles

Comparative Analysis and Ratio Analysis

Ratio analyses are extremely important in evaluating the reasonableness of reporting in a cash intensive business or in a business that carries inventory. A successful business will continually analyze its costs by using operating ratios. This ensures that all areas remain profitable and allows owners to make adjustments to product lines that report sluggish gains.

The cash business, as reported on the tax return, should be evaluated through the use of ratios. This is because relationships exist between income and expenses that creates a balance. The balance can be evaluated by using a vertical analysis of the tax return. Similarly, trends and practices are usually consistent over time, and these can be evaluated by using a comparative analysis between 3 or more years of tax returns.

When someone is misappropriating cash, it causes the relationships to become unbalanced, and this can be discovered by analyzing ratios.

Vertical Analysis and Industry Ratios

The first step in determining the reasonableness of the reported income and expenses is a vertical analysis that expresses each expense in terms of gross receipts. This is the method companies use to compare one business to another.

A vertical analysis is a comparative analysis within a given tax year of certain expenses relative to gross receipts. Thus, all expenditures will be expressed as a percentage of gross receipts. This is done by dividing the amount of the expense by the amount of gross receipts. For example:

	Example	
Gross Receipts	$100,000	100%
COGS	(25,000)	25%
Gross Profit	75,000	75%
Operating Expenses	30,000	30%

Bizstats.com offers free business statistics and financial ratios, by type of entity (sole proprietor, corporation, partnership), by industry (retail, beverage store, construction, etc.) and by amount of gross receipts. By entering the amount of gross receipts from the return into the Bizstats customized P&L report for the proper industry, Bizstats will prepare a benchmark vertical analysis that can be compared to the tax return. This analysis will tell the examiner how the business under audit compares with the industry as a whole. This does not indicate there is unreported income, but may raise some questions about the expenses that should be asked of the taxpayer.

Comparative Analysis

In a retail business the markup percentages usually remain constant from year to year. If goods are marked up 50% when the cost is $12, the goods sell for $18 and the business earns a profit of $6 on each sale. When the supplier increases the cost of goods to $14, the business, keeping the 50% markup percentage, sells it for $21 and earns a profit of $7 on each sale. This way, any supplier increases are passed on to the consumer.

Remember, when a supplier increases cost it is usually an increase to all of the supplier’s customers. Therefore, all retailers will increase their prices. For example, when the price of gasoline goes up, all stations increase their prices to maintain their individual profits. The examiner should not accept self serving statements that a retailer did not raise prices in order to be competitive. If the retailer’s prices do not increase with cost increases, the retailer will be undercutting the competition and the examiner can expect to see increased sales.

From 3 successive year's returns, a MACS return, a 3-year income statement or 4-year balance sheet, a comparative analysis can be performed. The various line items can be compared from year to year for large, unusual, or questionable items, and trends, such as continual large losses, can be identified.

Inventory Analyses

Businesses maintain inventory so they will have on hand the items their customers want. A business only makes money when the inventory sells or “turns over” , and the higher the turnover rate, the higher the profits.

Many cash intensive businesses are small operations and may claim no inventories are made, or that the inventory figures on the tax return are estimated. However, no business can order new supplies without knowing what they already have, so even if no formal inventory is taken, the person responsible for ordering must have knowledge of what is present. That person should be interviewed and asked about goods on hand and turnover rates.

A ratio analysis of inventory in relation to sales can show the true picture when no records are provided. A ratio analysis can also be used to find inconsistencies in the reporting. Following are some analyses an examiner may consider:

Gross Profit Margin or Percentage:

GROSS PROFIT ON SALES (from tax return) Ã· SALES (from tax return) = GROSS PROFIT PERCENTAGE

The examiner should make this calculation for the prior, current and subsequent years. Is there significant change between years? If so, tailor the interview-ask how the business was doing, if any changes were made. A drop in the gross profit percentage can mean sales are not recorded or money is not in register

Inventory Turnover:

COST OF GOODS SOLD (from tax return) Ã· (BEGINNING + ENDING INV) / 2 = the TIMES INVENTORY TURNED OVER PER YEAR

When turnover increases, the business is more profitable because items are sold faster, making room for new items to be sold. Compare the Inventory Turnover from the prior, current and subsequent years. If turnover increases you should see a corresponding increase in Gross Margin (sales). If one ratio is increased but the other isn’t, ending inventory may be understated.

Analysis of Ending Inventory Balances:

(ENDING INV - BEGINNING INV) Ã· BEGINNING INVENTORY = the PERCENTAGE OF INCREASE OR DECREASE in Inventory

The examiner should make this calculation for the prior, current and subsequent years. This measures the amount of inventory increase (positive number) or decrease (negative number) over the prior year. Inventory increases should result in higher sales. If sales have not increased correspondingly, the examiner should consider inventory items withdrawn by the owner for personal use.

Change in Net Sales from Year to Year:

(SALES in 2008 (from tax return) - SALES 2007 (from tax return)) Ã· SALES 2007 (from tax return) = the PERCENTAGE OF CHANGE in Net Sales from Year to Year.

This calculation shows how much sales increased or decreased from 2007 to 2008. If sales increased, the examiner should see a favorable Inventory Turnover Ratio and a corresponding increase in Change to Cost of Goods Sold. If sales increased and the expected changes are not present, sales are not reported or inventory may be a problem.

Change in Cost of Sales from Year to Year:

(COGS 2008 (from tax return) - COGS 2007 (from tax return)) *Ã·* COGS 2007 (from tax return) = the PERCENTAGE OF CHANGE in Cost of Sales from Year to Year.

If sales increased, the percentage of change to COGS should be consistent. Otherwise, inventory is understated.

Other Investigative Sources

Access Treasure Enforcement Communication System (TECS) Database-Passenger Activity Query and I-94 database

1. Only accessible via Criminal Investigation Division (CID)
2. Will show all inbound travel into the U.S. by any person presenting a passport. Information on passport will include dates, names, date of birth, point of entry and time.
3. Used to corroborate if taxpayer/lender/donor actually traveled into the U.S. from abroad on claimed dates.

Information could include assets or how much wealth the taxpayer brought into the country. This can be used to verify a taxpayer’s claim that someone traveled into the United States on a particular date carrying a cash loan or gift. An individual entering or leaving the United States with currency, OR a person shipping, mailing or receiving currency will complete FinCEN Form 105 (formerly Customs Form 4790).

Currency and Banking Retrieval System (CBRS)

Currency transactions can be an indicator of many compliance issues and these indicators need to be specifically incorporated in the audit plan and compliance effort.

The CBRS should be checked initially to determine the nature of the transactions that were netted up and matched to the return. Cash transactions over $10,000 just by nature are a very strong indication of possible underreporting of income and must be considered in every aspect of the audit. Each transaction must be addressed properly.

For the same business, a pattern of transactions may have very different indicators.
For example: A store with regular currency deposits may indicate substantial gross receipts that should be verified as cash as opposed to more conventionally traceable transactions (i.e. credit or debit cards). The same store with significant currency withdraws may indicate a check cashing or money service business operation, such as money order or Western Union sales. Consider the implication of each and possibly both during an audit.

The Bank Secrecy Act and Money Laundering Statutes were passed by Congress to help facilitate the identification and prosecution of individuals involved in illegal activities for profit.

The CBRS database can be used to identify bank accounts, secreted cash, leads to assets and foreign bank accounts, nominees and a myriad of other useful information for compliance and other law enforcement personnel. The following documents are currently available on CBRS:

Form 4789 - Currency Transaction Report (CTR) - Domestic financial institutions, including banks, credit unions, check cashing establishments, and currency exchanges are required to file a CTR on each deposit, withdrawal, exchange of currency, or other payment or transfer involving a transaction in currency in an amount greater than $10,000. Either cash-in or cash-out can generate the reporting requirements.

Form 8362 - Currency Transaction Report by Casino (CTRC) - Casinos are required to file a CTRC on each deposit, withdrawal, exchange of currency, gambling tokens or chips, or other payment or transfer which involves a transaction in currency of more than $10,000. Casino transactions must be analyzed from the source of funds perspective. While gaming may be a net loss operation, the source of the seed money must be addressed. It may be income of a non-gaming source before it becomes a net a loss.

Form 8852- Currency Transaction Report for Nevada Casino - same requirements as Form 8362 filed only by Nevada casinos.

Customs Form 4790 - Report of International Transportation of Currency or Monetary Instruments (CMIR) - Each person who transports or has transported currency of the United States, or any other country's traveler checks, money orders or investment securities, or any other negotiable instruments, in or out of the United States, is required to file this form.

Treasury Form 90-22.1 - Report of Foreign Bank and Financial Accounts (FBAR) - United States persons must both file this form and answer yes to the question on Schedule B of Form 1040 if they have a financial interest in or signature or other authority over a bank, securities or other financial account in a foreign country which exceeds $10,000 in total value at any time during the calendar year.

Form 8300 - Report of Cash Payments Over $10,000 Received in a Trade or Business - Required to be filed by any person who, in the course of carrying on a trade or business, receives more than $10,000 in cash in one transaction or related transactions.

Criminal Referral Form (CRF) - these forms are filed voluntarily by banks on unusual, suspicious, structured transactions and cancelled transactions.

Customs Form CF 7501 - Entry Summary (EXC) - Filed by importers or licensed customs brokers whenever commodities are imported into the United States. CBRS reflects only those commodities that are subject to excise tax.

Immigration Files

1. Files can reveal extensive foreign businesses owned by taxpayer, financial information, and foreign bank accounts.
2. Interrelationships identified.
3. Determine resident/visa status of individuals.

Information could include assets or how much wealth the taxpayer brought into the country. This can be important if the immigrant claims money was brought into the United States, and is not gross receipts earned in the business. This information can also be gathered for any individual immigrant who is identified as making cash loans to a business taxpayer.

Loan Application Files

1. Some loan applications may reveal income and assets, which differ from the original tax return filed.
2. Loan officer reports and interoffice memorandums detail taxpayer history and financial background. This may include files of taxpayer's related transactions, other lenders, or other sources of income.

Bank Records/Financial Records of Foreign Lender or Donor

1. Ask for copies of foreign lender/donor's bank records to show where money was withdrawn. Compare amounts deposited by taxpayer and how it exchanges to U.S. dollars.
2. If necessary, secure affidavit from foreign lender/donor stating dates, amounts, and other data regarding loan/gift.
3. If necessary, secure copies of foreign lender/donor's business records if amounts were withdrawn from a business.

Asset Locator Databases

Validate the taxpayers' real estate holdings, corporate ownerships, lawsuits, professional licenses, executive affiliations, bankruptcies, loans, etc.

- Electronic real estate service research (statewide or national, if available, access to historical/current real estate ownership)
- Secretary of State, bankruptcy, judgments, liens, court records, register agents, corporate officers nationwide, professional licenses, state income and sales taxing authorities such as Board of Equalization, Franchise Tax Board, Employment Development Department, plane and boat ownership, people finder, etc.
- Department of Motor Vehicles (vehicle ownership)
- Credit Bureau - address information

Method for confirming assets of taxpayer/donor/lender outside of immediate area. Historical changes in property ownership are available. Access usually covers statewide as well as nationwide.

Interviewing Actual Foreign Lender/Donor

A third-party interview of the foreign lender/donor (if present or residing in the U.S.) can be useful.

- Have taxpayer set up interview.
- If necessary, conduct interview under oath.
- Evaluate for credibility/conflicting testimony.
- If examiners must, issue summons to appear
- Consult Area Counsel.

Interviewing Other Potential Witnesses

On some occasions an interview of other individuals, not a party to a questionable transaction may be necessary.

1. These individuals may include:
    a. Former business associates
    b. Spouses
    c. Relatives
    d. Employees
    e. Friends
    f. Competitors
    g. Vendors
    h. Customers
    i. Other government agencies
2. Take affidavit

3. Issue summonses when necessary to compel testimony or produce documents.

These witnesses can provide detail about related business practices and can confirm or contradict credibility of information received by the examiner. Review the disclosure rules for third party contacts.

Summons U.S. Parent Bank for Records Located in Its Foreign Branch

Summons U.S. Parent Bank for Records Located in Its Foreign Branch

When a taxpayer has conducted one or more transactions at a foreign branch of a U.S. bank, the transactions can be examined by summonsing the U.S. parent office of the U.S. bank to obtain the foreign branch's records.

- United States v VETCO, 691 F.2D 1281 (9th CIR. 1981), cert denied, 454 U.S. 1098 (1981).
- GARPEG v United States, 583 F Supp 789, 84-1 U.S.T.C. 9323 (1984), 53 A.F.T.R. 2d 1309 (S.D.N.Y. 1984)

This can reveal foreign transactions and possibly foreign bank accounts. Be prepared to enforce the summons if necessary.